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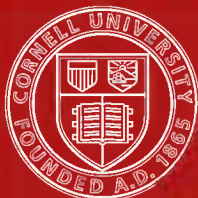
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CORPORATION FINANCE

PART II

DISTRIBUTING SECURITIES REORGANIZATION

BY

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PREFACE

SINCE the publication of *Capitalization* in 1912, suggestions have been made from time to time that a discussion in the same general manner of other topics of corporation finance would be helpful to students of the subject.

The new volume, *Corporation Finance*, accordingly, deals more especially with two topics, the distribution of corporate securities and the financial side of corporate reorganizations. It also presents some discussion of the disposition made of corporate income. Though both law and accounting must be referred to in explaining financial matters, I hold an opinion that corporation finance has a distinct channel, and that it is the duty of any one undertaking a presentation of any aspect of the subject to steer a course between the legal and the accounting sides of corporate business.

Since writing *Capitalization* I have changed my mind about the special desirability of using as illustrations existing securities and corporations, and in this second volume have confined the examples mostly to hypothetical cases. The passage of a few years, with their

varying economic, social, and personal winds, make the facts presented in an old corporation manual resemble the snows of yesterday.

I am glad to express my appreciation of the kindness of Mr. John Tatlock, president of the Westchester Avenue Bank, in reading much of the manuscript. My partner in the practice of the law, Mr. William Lilly, helped especially with the discussion of Corporate Reorganizations.

HASTINGS LYON

37 WALL STREET, NEW YORK CITY

August, 1916

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CORPORATION FINANCE

CHAPTER I

RAISING FUNDS FOR THE CAPITAL ACCOUNT THROUGH AN APPEAL TO THE STOCKHOLDER

PEOPLE who are starting a new corporate enterprise must in some way provide the capital for it. Finding the capital forms part of the work of the promoter. When performing this labor he often resembles Gilbert's policeman in that "his lot is not a happy one." He is too likely to have to cool his heels in many an anteroom before he accomplishes the desired result. In the discussion of "Watered Stock" in the preceding book on *Capitalization*, we have already indicated something of the nature of the promoter's services and the method of rewarding them. For the present let us assume a corporation in existence and conducting a going enterprise. When the managers of such a corporation decide that the business requires new capital, or that new capital could be used to advantage in the business, they can attempt to procure it directly through the corporation or they can seek the aid of other

people who make a business of procuring capital for corporations.

If those in control of the affairs of a corporation seek the aid of those who make an occupation of providing capital, — investment bankers or brokers, or, to use a term which includes both, dealers in securities, — they must pay these people for their services. Naturally the question arises whether or not the corporation can cut out the middlemen and, by appealing directly to those who have capital to invest, get the entire amount of funds which the investor is parting with. Of course this question is simply the special part the distribution of securities plays in the whole general question of the middleman and his rewards. It is no part of our purpose, however, to enter at length into the general question, but simply to discuss the issue with special reference to securities.

Corporations have not been successful in making an appeal directly to the capitalist. By capitalist we mean only some one with money to invest, whether large or small in amount, some one who controls capital to a value of from one hundred dollars up to many thousands. Locating the capitalist and persuading him to invest his capital in a particular enterprise requires special skill and influence. When a dozen opportunities

to invest are being offered skillfully and influentially, as is always the case, an offering made without skill and influence is not likely to meet with acceptance.

Middlemen, or dealers in securities, perform a real service. Some description of the manner of performing this service will appear as our discussion develops. A corporation engaged in the special business which it was organized to carry on does not have the facilities, to say nothing of the special knowledge and ability, to engage in the business ordinarily carried on by the dealer in securities. A given corporation ordinarily demands new capital only at considerable intervals. It cannot maintain a permanent organization to satisfy these occasional demands.

Dealers in securities make a business of doing for many corporations what, for any one of them, though probably their most important affair, is one that ordinarily demands attention only at infrequent and irregular intervals. They perform services of two kinds. They do the actual work of inducing the capitalist to make his commitment in the particular enterprise, and they assume the risk of success in performing this service. Generally speaking, corporations do not meet with success in new financing unless they can and do command both serv-

ices. People who are willing to act as brokers for a corporation in selling its securities on commission, and without assuming the risk of the market, naturally will not sell if they find selling so difficult as to be unprofitable. Ordinarily corporations resort to dealers of that character only when they fail to find some dealer who will assume the risk. Generally only small corporations attempt to raise funds in that way, and then the attempt usually results in disappointment.

Risk in these transactions is a very real thing. The most skillful and best informed in these matters may fail to estimate correctly the appeal a particular issue of securities will make to the public at a given price. Even if they are not mistaken in their estimate of the popularity of the issue, general, financial, and business conditions may shift rapidly, before the securities can possibly be disposed of, and cause the bankers who have purchased or underwritten them a heavy loss. The corporation can well afford to pay for the insurance. Generally it is almost a vital matter that the corporation secure the money and usually a relatively small difference in the cost of securing it is not at all vital. If the corporation is carrying through a refunding operation, creating

a new issue of bonds to sell and to enable it to pay off bonds which are falling due, it must have the money or suffer a default. If the corporation requires new capital for extensions, it may be of the utmost importance to it, under the conditions existing, that the new capital expenditure be made. Though the difference between a $5\frac{1}{2}$ per cent and a $5\frac{3}{4}$ per cent basis — which would be a difference between 93.25 and 90.12 in the price of a 25-year 5 per cent bond — is important, it is not vital.

Though it may not be expedient generally for a corporation to turn itself into a banking house in the endeavor to raise capital without the expense of the services of a middleman, it may under some circumstances procure for itself new funds required. The corporation may be a “family” affair: that is to say, a very few people may own practically all of the stock and may not want any “outsider” to have a substantial interest in the business. Many such corporate businesses conduct their affairs much in the manner of a partnership. People who are essentially partners organize in the corporate form for the sake of the limited liability, for the precision of the corporate form in providing for the contribution of capital and division of profits, or for any other of

the advantages which the corporate form possesses. The stockholders are so few and so closely associated that they are like a family. Often more literally family corporations conduct business enterprises. Such corporations frequently result from the death of the man who established the business and during his lifetime carried it on as his personal enterprise. On his death, in order to keep the business in the family and provide for its management and the distribution of profits, it is incorporated. Under such circumstances the existing stockholders may be able and may prefer to supply any new capital needs of the corporation.

Many corporations cannot appeal to the banker for help. No financial organization may have been developed to procure capital under the special conditions. At the time of writing banking organizations are adequate to supply the financial needs of any railroad, electric railway, gas, electric light, or hydraulic electrical enterprise which economic conditions justify. These are, of course, the kinds of business which, as shown by the principles developed in the discussion, in the previous book on *Capitalization*, of "Trading on the Equity," are, when once established, least subject to business risk. Our financial organization is also adequate

to procure capital for the larger industrial enterprises. Even for these, however, it is not as well developed as for the public service corporations. Many smaller industrial enterprises, thoroughly justified by economic conditions, cannot obtain capital through well-organized established channels. It may be objected that the amounts involved in these smaller enterprises do not justify the effort bankers must make to raise the capital. Many of the costs would be nearly as large as for the big capital demands of the great corporations. Costs of investigation and of advertising in various ways, to make the enterprise sufficiently well known to command capital, would be disproportionate to the amount of capital required. The banker would have to charge enough for his services in such a case as actually to impose too heavy a burden on the business. Bankers, however, have overcome such difficulties for the smaller public service enterprises, and in the course of time will probably devise means for providing capital, in spite of the greater business risk, for the smaller industrials. Meanwhile those in charge of the affairs of these smaller industrial enterprises must get their capital as best they can. Such as they cannot provide themselves they must appeal to acquaint-

ances for. On a personal appeal men familiar with the industry of which the particular enterprise is a part may see an attractive opportunity for a commitment of capital. So from various sources the managers of the enterprise find the necessary capital.

Family corporations and the small industrials do not, however, compose the large body of corporate enterprises which present the problem of raising capital we are discussing. Generally a corporation which can procure capital through the regular channels of the banking houses had better take advantage of the opportunity and not attempt financing itself.

Under some circumstances, however, a corporation that is not a family affair may successfully finance itself. Especially if it had a surplus and its stock has a market value substantially above par, it may, on condition of cutting down the surplus, successfully appeal for funds. It may do this by taking advantage of the fact of the surplus, in connection with the right of its shareholders to purchase any additional capital stock the corporation may be issuing for cash.

We will have to delay at this point to explain, for the benefit of those who may not

be familiar with them, the various procedures possible in the issuance of corporate stock. The chapter on "Watered Stock" in the first volume on *Capitalization* gave some indication of the process of "getting stock out" as fully paid on the transfer of property to the corporation. Ordinarily the incorporators transfer the property at the time of incorporation in order "to get the stock out," as the phrase is, and put the corporation in a position legally to begin business.

The organizers of the corporation may, as described in the earlier chapter, distribute none or only a part of this stock, to satisfy the interests of the various parties to the launching of the corporate enterprise. The organizers may have had the stock issued as fully paid stock on the transfer of the property only to get the corporation into a better strategic position for future financing. If that is the case, they will hand back to the corporation such part as they do not require for the purpose of carrying out the bargain under which it was formed. Stock so turned back to the corporation, or "donated" as the process is termed, carries the name of "treasury stock." Of course the lawyer in charge of the incorporation proceedings must be careful to comply with all legal require-

ments, and must incorporate in some jurisdiction which enables him to carry the transaction through without jeopardizing the position of directors and shareholders.

To explain the matter more clearly, let us consider a supposed situation of a corporation which has provided for future financial requirements. We will assume that the charter of the corporation authorizes \$2,000,000 of preferred and \$6,000,000 of common stock. The organizers had the corporation issue and distribute all the preferred stock. They had property transferred to the corporation for which it issued \$4,000,000 of common stock. Of this common stock, so issued, they had \$2,000,000 donated back to the corporation. We will assume, too, that the corporation has given a mortgage under which it may issue \$5,000,000 bonds, of which it has actually issued and sold \$1,000,000. The capitalization, then, will stand in this way: —

Capitalization

	<i>Authorized</i>	<i>Issued</i>	<i>Outstanding</i>
Common stock	\$6,000,000	\$4,000,000	\$2,000,000
Preferred stock	2,000,000	2,000,000	2,000,000
Bonds	5,000,000	1,000,000	1,000,000

Let us now also assume a balance-sheet for our corporation. We do not recommend this balance-sheet as a model for accounting practice, but present it simply to illustrate certain financial facts: —

<i>Assets</i>		<i>Liabilities</i>	
Real estate plant and equipment...	\$5,000,000	Common stock issued and outstanding.....	\$2,000,000
Material and goods, inventory.....	350,000	Preferred stock issued and outstanding.....	2,000,000
Bills and accounts receivable.....	150,000	Bonds issued and outstanding.....	1,000,000
2000 shares of common stock held in treasury.....	0	Bills and accounts payable.....	200,000
		Surplus.....	300,000
	<hr/>		<hr/>
	\$5,500,000		\$5,500,000

The 2000 shares of common stock which have been issued and given back to the corporation are not, of course, an asset. When outstanding they will become a liability represented on the assets side by whatever are the proceeds of their sale. Rather than being placed in the assets column, a notation might be made to indicate the situation. They do represent a greater freedom of action on the part of the corporation in its financing. If the corporation has only authorized and unissued stock to dispose of, in order to raise cash it must get par for that stock. It may generally, to be sure, pay a reasonable commission for selling it. Even

with this limitation the corporation obviously must realize a certain minimum on a cash sale of any of its authorized but not theretofore issued stock. If the corporation, however, has some so-called treasury stock, it may generally deal with that stock substantially as it pleases. Of course the directors must obtain a price fair to the corporation and otherwise see that the sale does not injure existing stockholders.

Many jurisdictions, both by statute and by judicial interpretation, have been making it increasingly difficult for the managers of a corporation to arrange any way for the corporation to sell any stock for less than par. On the other hand, some jurisdictions have come to a recognition of the true business situation as outlined in the earlier chapter on "Watered Stock." Though at the time of this writing the idea of "stock without par value" has not received much legislative recognition, the fact of an increasing number of people who appreciate the truth back of it gives rise to the expectation that it will receive more general legal adoption. The difficulty and often impossibility of steering a legal course for a corporation to sell stock for less than par causes much of the unsound capitalization plans. If the stock of a corporation is not worth par, and yet the di-

rectors may not legally arrange for its sale at less than par, they must resort to borrowing, — that is, to the issuance of bonds. So the fixed charges become disproportionate, as explained in the discussion of “Trading on the Equity,” and endanger the control of the shareholders.

If the corporation has no treasury stock at its disposal, it may, nevertheless, not have exhausted its authority to issue stock: that is, it may not have issued all the stock authorized by the charter. If it has not, the stock not yet issued is called, as we have indicated, “authorized and unissued stock.” If the corporation has exhausted its authority to issue stock, it must procure additional authority from the State before it can finance itself on stock. Unless the charter permitted by the law of the State gives to the corporation authority to sell unissued stock without first offering it to stockholders, the directors must offer the existing stockholders a right to purchase, in proportion to their present holdings, the stock about to be issued and sold. Directors who have treasury stock of the corporation available are generally not obliged to give existing stockholders a chance to purchase ahead of any one else. They can come to a fair bargain with bankers and sell them the treasury stock. As

already stated, the price need not be equal to par or it may be any price above par.

Since stock which is merely "authorized and unissued" is often called "treasury" stock, we need to emphasize the distinction. Treasury stock has been issued or "gotten out," to use a common phrase, and in some way, usually by gift, returned to the corporation. That is, the corporation has a right to sell the stock for the benefit of the corporation. The incorporators can generally get the stock issued at the time of incorporation more easily than later. Property is being turned over to the corporation for which stock can be issued in payment. It is agreed that some of the stock be given back just in order to afford the corporation the greater freedom of action in disposing of it. A corporation cannot as a general principle buy back its own stock. That would diminish the fund to which creditors have a right to look for security. As already stated stock received back by the corporation cannot be an asset, any more than a promissory note bought back by the maker before its due date is an asset of the maker. Special statutory provisions in some jurisdictions to some extent modify the general principle that a corporation cannot buy back its own stock, but even these are likely to amount to provisions for a reduction of capital stock

and require essentially an amendment of the charter.

When arranging for the issuance and sale of unissued stock, the directors must first offer the stock to the existing shareholders. That requirement would not in itself irksomely restrict the management. But some jurisdictions clearly hold that existing stockholders have a right to subscribe, in proportion to their holdings, to the new stock at par. If the stock is worth more than par, obviously a sale of new stock at par amounts to a partial distribution of surplus. Though the management may not consider such a course good policy, they cannot help themselves in such jurisdictions on a sale of authorized and unissued stock. Since the right of the existing stockholder to subscribe at par for new stock seems in accord with the principles of the common law, the management would make the offering at par unless in a jurisdiction where statute or judicial decision had established another principle. Massachusetts, for example, by statute requires that quasi-public corporations must offer any increase in capital stock to their shareholders at a price to be determined by the Public Service Commissioners of the State.

This necessity for offering unissued stock first to existing shareholders requires that

the bankers, if they are called in, handle the situation in a special way. It may be that the management of the corporation feels it to be important that the funds for which the stock is being sold should be assured. They may not be willing to take the chance that stockholders will supply all of it. Or, if the situation is such that they might feel reasonably confident that the appeal to the stockholders would procure all the funds, they may wish to have the whole transaction handled by those who are expert in the business, and be willing to pay bankers for their services. In any event, bankers cannot make an absolute purchase of the stock on their own account unless they are ready to turn round and offer the stock to shareholders at the same price the bankers have just paid to the corporation for it. If the stockholders should take it all at this price, the bankers have had their labor for nothing. If the stockholders should not take it all, the bankers, in order to get any return for their work, would have to offer the rest to their clients at a higher price. Since such a matter as the price to the stockholders cannot be kept secret, obviously the bankers would not meet with success in offering the stock to their clients at a higher price.

Under such circumstances the corpora-

tion, instead of arranging for an immediate sale of the stock to the bankers, gets the bankers to underwrite the issue. The terms "underwrite" and "underwriting," as we shall consider in a later discussion, mean various things as loosely used in current financial talk of the street. Just at this point we are using the word in its more nearly original sense in the business of insuring. The bankers, on the payment of a stipulated sum called an "underwriting commission," the equivalent in this case of a premium for insuring the success of the transaction, agree to "take up" or purchase any of the stock which the existing stockholders do not buy. Or, it may be that the corporation, after offering the new stock to its stockholders, may make a public offering of the stock. It could make a public offering, and prefer the applications of its own stockholders. In any event, the bankers agree to buy at the issue price any of the stock or other security which the corporation does not succeed in selling. Since the bankers are receiving an underwriter's commission for their service as insurers, they can continue to offer the stock to their clients at the same price that the corporation was asking, and, if they are successful in selling, they will have received something for the transaction.

To illustrate the situation, suppose the corporation wishes to sell \$3,000,000 of stock. Assume that the stock is of the "authorized and unissued" class which the corporation must offer to its stockholders at par. Let us assume that the essential facts for the purpose of our discussion are these: The corporation has assets which on an appraisal would be given a reproduction value of \$12,000,000. It has net earnings of 10 per cent on this value. Since a bond issue would only confuse the discussion, we will assume that the corporation has no bonds, but has a stock issue of only \$9,000,000 of common stock outstanding of a total of \$12,000,000 authorized. We will assume further that the directors estimate that the corporation can earn 10 per cent on a further investment of \$3,000,000, and that they consider the investment desirable for the better protection of the capital already committed to the enterprise. Stating these facts in tabular form in order to have them more clearly before us: —

<i>Assets</i>	<i>Liabilities</i>
Reproduction value of plant and other assets \$12,000,000	Stock outstanding \$9,000,000 (\$12,000,000 authorized)
Net earnings \$1,200,000; or, the corporation is earning 13 $\frac{1}{3}$ per cent on the outstanding stock.	

Let us assume that the stock is selling at 133, or approximately a value of \$10 for each one per cent of earnings.

Now let us assume that the corporation arranges to sell \$3,000,000 of stock at par, that the proceeds will be advantageously expended on the capital account of the corporation, and that the corporation will be able to increase its net earnings by the amount of 10 per cent on the new assets. The statement will then change to this form:

<i>Assets</i>	<i>Liabilities</i>
Reproduction value of plant and other assets \$15,000,000	Stock outstanding \$12,000,000
Net earnings \$1,500,000, or, the corporation will be earning $12\frac{1}{2}$ per cent on its capital stock.	

Obviously, under these circumstances the stock of the corporation, after the issuance of the new stock, will not be worth quite so much as before. Though in the case we have assumed, the issuance of the new stock will not make a great difference, it will, nevertheless, make a measurable change. If the estimates prove correct, net earnings on outstanding stock will decline five sixths of one per cent. We have placed a theoretical value on the stock for purposes of our discussion of \$10 for each one per cent of net earnings on the stock. On that basis the stock, after the new stock is issued, should

be worth approximately \$8.33 less a share than it is worth now.

Clearly this result must follow any issuance of new stock sold at par whenever the corporation has a real surplus, unless the corporation can increase its rate of earnings by reason of the new capital. It may be that the new capital will enable the making of improvements that will increase the per cent of net income the corporation can earn on capital invested in the enterprise. If it is anticipated that such a result will follow, of course the value of the stock will not decline with the new issuance. Unless the rate of earnings will increase, any issuance at par of new stock of a corporation with an actual surplus must mean a reduction of the amount of surplus to each share of stock outstanding, or of the total assets for each share with which the corporation can earn an income return for that share. In the case we have just assumed, the capital and surplus for each share, as measured by the appraisal of the assets on a reproduction basis, amounted to $\$133\frac{1}{3}$ per share, and, after the issuance of the new stock, capital and surplus for each share amount to \$125. It happens that in the problem we have taken, the ratio of assets and the ratio of earnings remains the same. This would not always

be the case. Regularly the market price of the stock would be based on net earnings rather than on assets, and assets taken into consideration primarily as indicating something of the probable continuance of earnings. Though all our discussion about the effect of the new issue, so far as determining exact prices of the stock is concerned, is highly theoretical, probably actual results under similar conditions would approximate our entirely theoretical results.

Under such circumstances as we have discussed the corporation can readily obtain new capital on an appeal to its own stockholders. The corporation can finance itself. Acting in accordance with the principles we developed in our discussion of "Trading on the Equity," it may prefer to borrow the new capital it desires. In that event it will arrange for an issue of bonds instead of planning to issue more stock. Such circumstances as we have described, however, of a substantial surplus, and an income which tends to show that the surplus is not just a matter of bookkeeping, but causes the stock to sell at a considerable premium, do not compel the corporation to resort to borrowing because it cannot legally obtain capital increases in any other way. Let us consider how an appeal to the stockholders for new

capital could be made, and the way it would work out.

Assume that our corporation has announced its intention of raising new capital by offering to its stockholders at par \$3,000,000 of its authorized and unissued stock. Note that the present issued capital stock amounts to \$9,000,000. An increase of \$3,000,000, under the legal principles we have stated, whereby a stockholder has a right to subscribe to new stock in proportion to his present holdings, would give the holder of three shares of the old stock a right to subscribe to one share of the new. Or, a holder of one share of the old has a right to one third of a share of the new. Though the holder of a single share of the old stock cannot get an actual fraction of a share of stock, the right to a third of a share cannot be taken away from him. This reads like a paradox. We mean that the holder of a single share has the right either to sell his right to subscribe for the new stock, or to purchase the rights of the holders of two other shares, and in this way complete his power to demand a share of the new stock. This is what is meant by a "right" when the term is used in speaking of the offering of new stock to the existing body of stockholders.

Directors of the corporation announce that

stockholders of record of a stated day will have the right to subscribe for the new stock in the proportion of one share of the new for three shares of the old. This announcement — at least, that part of it which says “stockholders of record of — day of —” — bears some resemblance to a declaration of a dividend. As we shall see, the transaction resembles a declaration of dividends in more respects than just its language. Through these “rights” the stockholders are about to get an immediate distribution of surplus in a way that amounts to an extra dividend.

We have assumed that the old stock is selling at about 133 and that after the increase the stock of the corporation will be worth about 125. On this basis a man owning three of the old shares has the right, on paying \$100, to buy a share of stock which will have a market value of \$125. Since a single “right” — that is, the interest of one share of the old stock in the issuance of the new — may be bought and sold, obviously the value of this right equals one third of the \$25 which the holder of three shares may realize on exercising his right to subscribe. Or, to state the situation briefly, each right has a value of \$8.33. For the sake of clearness let us show the transaction in tabular form: —

Total stock outstanding.....	\$9,000,000
Amount to be issued.....	3,000,000

Right: — three of old to subscribe for one of new } †

Market value of new stock.....	\$125.00
Subscription price for new stock.....	100.00
Value of subscription rights of three shares of old stock.....	25.00
Value of right.....	8.33

It is not to be assumed that these values all settle themselves in the precisely accurate mathematical manner indicated. Probably the price of the old stock fluctuates a good deal in anticipation of the announcement of the forthcoming rights. Though we have taken too small a corporation for our discussion to represent a reasonably typical issue of stock listed on the New York Stock Exchange, the results come to the same thing as if we had multiplied the amounts of old and new stock by three or four to present an issue of Stock Exchange size. Dealings in rights will begin immediately on the announcement that they will be given. The corporation will issue, to stockholders of record of the day stated, certificates representing the rights, and these certificates will be handled in just the same way as the certificates of shares of stock themselves.

So by making this appeal to and through its own stockholders, a corporation with a

real surplus, part of which its managers are willing to distribute and have represented as capital stock rather than as surplus, can raise new capital without resorting to the bankers. Instead of increasing its capital stock the corporation may even borrow in this way by offering bonds to its own shareholders at something less than their actual market value. Presumably the corporation has a perfect right to do this so long as it gives to each stockholder the right to subscribe in the manner just outlined, and provided it is not by so doing impairing the capital of the corporation.

If the stock of the corporation is selling only a little above par the situation offers less assurance that the corporation will be able to raise new capital by an appeal to its own stockholders. Issuance of new stock may reduce the market value of the stock to a point where a general decline in the market may carry the price to par or below. To illustrate this situation, assume a corporation with —

Stock outstanding.....	\$25,000,000
To be issued.....	5,000,000
Market price for old stock.....	105

To cut our computation short by using the market estimate of values, the capital and surplus of the corporation has a value, on

the market price of the stock at 105, of \$26,250,000. On realizing par for the \$5,000,000 new stock, the capital and surplus of the corporation will have a value of \$31,250,000. But the corporation now has 300,000 shares of stock, so each share should be worth approximately 104. At this price the rights would be worth only 80 cents. On a decline of two points in the market for the stock, they would have a value of only 40 cents. Unless one owned a considerable number of shares this is hardly a sufficient inducement to put through the transaction in order to realize on it. With a price only four points above par a very small general decline in prices would wipe the premium out entirely and carry the quotation below par. Of course no one would pay the corporation par for stock which can be bought on the market at less than par. A situation like this, with so narrow a range of safety in the market, perhaps hardly affords a sound enough basis for a banker to underwrite the new issue of stock. Certainly, if the raising of the new funds were of great importance to the corporation, it could not safely rely on procuring them from stockholders without getting the banker's insurance.

We have dwelt at some length on the principles underlying an estimate of the value

of the stock of a corporation after a declaration of rights. Of course in practice the matter is taken care of by the market estimate. We are assuming now a stock with an active market. When the corporation announces its new issue and the right of shareholders to subscribe at the terms offered, dealing in the rights will begin immediately. Assume our former case, in which we estimated the value of the rights at \$8.33. The market will probably place an estimate on the value of the rights at about that point, and the market value so estimated will indicate at what price the stock will sell when it goes ex-rights. When the stock goes ex-rights the corporation will issue certificates to the stockholders of record at the designated time. Up to that time trading in the rights will be for delivery when issued, and the price of the rights will approximately indicate the quotation on the stock when it goes ex-rights.

The price of the rights may not be exactly their value computed in terms of the price of the stock. It is likely to run a little less. Otherwise a stockholder desiring to sell his rights would not afford a purchaser a good bargain. The purchaser might just as well buy the stock without taking the trouble to buy the rights first. Rights are likely to sell at a point that will give an opportunity for

a possible arbitraging between the quotation on rights and the quotation on stock. If, for example, the rights we have been discussing, which entitle the holder of record of three shares of the old stock to subscribe for one share of the new at 100, were quoted at 7.75, and the stock were selling ex-rights at 125, they would afford an opportunity for a successful arbitrage transaction.

Under the stated circumstances let us suppose a speculator has been able to pick up 300 rights at an average price of \$7.75, and the quotation on the stock remains at 125. He can assure his profit on the transaction by selling 100 shares short at 125. At the designated time he can present his certificates for rights to the corporation and get a certificate for 100 shares on the payment of \$10,000. Let us see how he has come out on his transaction:—

Cost of 300 rights at 7.75	\$2,225.00
Cost of 100 shares at 100	10,000.00
Cost of Commission on short sale	12.50

Costs.....	\$12,237.50
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Realized on short sale of 100 shares at 125	\$12,500.00
Less costs of transaction	12,237.50

Profit on transaction	\$262.50
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These figures are given simply for clear-

ness of illustration. Probably the rights would not sell low enough to make such a profit possible. The costs include something more than those stated — as the transfer tax and interest on the \$2225 capital tied up in the rights during the interval before the certificate could be obtained on the subscription from the corporation. Some speculative risk would be involved, during the time required to pick up the rights, of the quotation of the stock declining or the price of the rights going up before enough were acquired to complete the transaction.

It should be mentioned that though in the New York market a right is that interest in the new stock which belongs to one share of the old, in some markets the term is used as meaning that interest in the new stock which entitles one to subscribe to one share.

Stockholders usually greet with pleasure an announcement of forthcoming rights. So far as the offering of the rights may indicate the opinion of the directors that the corporation may now distribute its earnings a little more freely, it affords a proper basis for self-congratulation on the part of the stockholder. But of course the corporation cannot lift itself financially by its own boot-straps. If the directors have been declaring dividends at the rate of 8 per cent per annum

and are likely to continue an 8 per cent rate on the new stock, the stockholders are getting greater immediate benefits from their holdings. Before the issuance of the new stock the corporation was earning, we assumed, $13\frac{1}{3}$ per cent on the outstanding stock. On an 8 per cent dividend rate, they were carrying $5\frac{1}{3}$ per cent to surplus. After the issuance of the new stock to stockholders at par, we assumed that the corporation earns $12\frac{1}{2}$ per cent on the stock outstanding. Now on an 8 per cent dividend the directors will be carrying $4\frac{1}{2}$ per cent to surplus. What constitutes proper surplus provision depends, of course, on the nature of the business. Assuming that $4\frac{1}{2}$ per cent on the amount of stock outstanding in this case makes ample provision for surplus, then the giving of rights has resulted in benefit to the stockholder. A present payment is of greater worth than one deferred. The offering of the rights raises a presumption in the mind of the stockholder that the dividend rate will not be cut, and that he will get the benefit of this immediate greater distribution.

If the management should be in a legal position to sell the stock at a premium so that they could obtain the full market value for it, they could treat the stockholder just

as well as under the plan of offering rights. To give the same results in an increased distribution they would have to increase the dividend rate, and an offering of new stock at the premium would raise no such presumption of increased distribution as an offering of rights. Market considerations, however, may favor the offering of rights rather than the sale at a premium. Distribution of the new stock by means of rights probably absorbs much of the shock of throwing a large block of new stock on the market. If the old stock were selling at 133, it is improbable that the new stock could be sold at that price. Even though the stock of the corporation would be worth just as much if the corporation should realize 133 for the new stock and could continue, as we assume, to make as large returns from new capital in the enterprise as on the old, still the sudden large increase in the market supply would depress the market price. In the case of the rights the expectation of the increased distribution of earnings acts as an offset to the depressing influence of the increase in the supply of stock in the market. Probably, too, more stockholders, rather than selling the rights, actually purchase the new stock on a granting of rights than would purchase at a premium that would represent the full

market value. So the offering of the rights probably in this way widens the demand.

Aside from these market and psychological considerations, theoretically the results should be the same in the long run whether the corporation gives its stockholders rights or sells at the full obtainable price. Assume in the case of our corporation that the directors were able to sell the stock at 133, the same price as that of the old stock. The sale of \$3,000,000 of par value would then realize \$3,990,000. If the corporation, as before, earns 10 per cent on the capital committed to the enterprise, net earnings will now increase by \$399,000, from \$1,200,000 to \$1,599,000, or $13\frac{1}{3}$ per cent on the \$12,000,000 of stock now outstanding. Theoretically the stockholder would be a little better off in this case than in the distribution of rights. According to our earlier calculation, if the corporation received par for its new stock, net earnings on the total stock would be $12\frac{1}{2}$ per cent. The corporation could carry $4\frac{1}{2}$ per cent to surplus and distribute 8 per cent. If the corporation could sell all the new stock at 133, it would, as just stated, be making $13\frac{1}{3}$ per cent on its total stock. It could carry $4\frac{1}{2}$ per cent to surplus and distribute $8.83\frac{1}{3}$ per cent to stockholders. A stockholder owning four shares of stock and

purchasing a fifth at 100 would have five shares on which he would be receiving an annual income of \$40. If he should purchase one of the new shares at 133, he would, under the conditions assumed, have five shares from which he would have an annual income of \$44.16 $\frac{2}{3}$. This would be a difference amounting to 12 $\frac{1}{2}$ per cent on his extra investment of \$33. This is really, however, at the expense of the surplus of the corporation, because the 4 $\frac{1}{2}$ per cent on the stock carried to the surplus account is \$540,000, but in the latter case it is on greater assets and therefore really a smaller surplus reserve.

Highly theoretical considerations of this kind, however, have little value, and we have not attempted, in the discussion at this point, to do much more than bring out that fact. The legal situations discussed are usually controlling, and if they should not be controlling market considerations would govern the decision of the directors as to the method of placing the new stock on the market.

Question may arise in the mind of some one about the rights of preferred stockholders to participate in a distribution of new stock. The New York courts, at least, have held that when preferred stock is entitled to cumulative dividends at a fixed rate and to preference in the distribution of assets,

and to no further dividend or distribution, and the preferred dividends are paid and the capital of the corporation unimpaired, the corporation is not obliged to allow preferred stockholders to subscribe to the new stock. It hardly needs saying that the holders of convertible bonds do not have a right to subscribe to new stock. The stockholder's legal right to subscribe is limited to new stock sold for cash. The presumptive right of the stockholder does not apply to an issue of stock in payment for property.

The discussion set out in this chapter has sought to bring out the possibility of a corporation financing new capital requirements by an appeal to its own stockholders and to show the considerations surrounding that possibility. Incidentally have been mentioned as briefly as possible some legal considerations governing the issuance of new stock, which indicate that the directors of a corporation, when they contemplate financing on new stock, may not have a free hand to do whatever they might consider most desirable as a financial expedient. Questions arise which are matters of grave consideration for the lawyers in charge of the legal side of the new issuance, and involve careful scrutiny of the statutes and decisions of the particular jurisdictions involved.

CHAPTER II

RAISING FUNDS THROUGH THE BANKING HOUSES

IN the preceding chapter, "Raising Funds for the Capital Account through an Appeal to the Stockholder," were mentioned two reasons why corporations, if they can, generally resort to the banking houses to raise new funds for the capital account. It pointed out that corporations are not equipped to do this work, which is never more than occasional in character, and that they ought not to take the risk of failure to raise the required amount of funds, if they can avoid it. We should add as a further and important reason the professional character of the banker and his ability to give expert advice in financial matters. It is the business of the banker to know the market, to know what kind of securities will be most acceptable to it at a given time. Are capitalists at the moment speculatively inclined? If so the time may be opportune for an issue of stock rather than for an underlying security. Or do capitalists show a conservative tendency and a preference for the promise of interest rather than for a hope or expectation of dividends? Are

interest rates high or low? If the corporation is to finance on an underlying security, should it run for a short or for a long term? On all these matters, discussed in the first volume in the chapter on "The Market and the Price," the banker is an expert, and if the corporation were to undertake the work of raising funds directly it would find it highly advantageous to seek the banker for professional advice. On all such matters as those discussed in the chapter on "Form of Securities," the corporation needs the advice of the banker.

Just how does the corporation establish its relations with the banker? It is difficult to generalize. Sometimes the banking house was interested in the enterprise at the time of its promotion. The chapter in the first volume which discusses "Watered Stock" indicates something of the nature of this relationship. Some banking houses refuse, under any circumstances, to be interested in enterprises in the promotion stage. Others will, very rarely, concern themselves with a promotion. Some organizations, partly banking and partly engineering in character, are rather frequently interested either in the promotion of a new enterprise or in such a reconstruction as amounts essentially to a promotion.

A banking house which takes the position of a promoter does not appear publicly in its banking house capacity as a promoter, or as in any way interested in an enterprise in its promotion stage. When the enterprise has demonstrated an earning power through actual operation, the banker may appear publicly as identified with the undertaking. We are interested at this point, however, in the banker as promoter only as showing one of the ways in which the relationship of banker to a corporation may originate.

If the corporation went through its promotion period without any banker, and its organizers raised the necessary capital as best they could among themselves and their friends and such capitalists as they might reach, later, when it needed to make an addition to the capital account from funds raised from sources outside itself, presumably the officers sought a banking house that would undertake to provide the funds. Usually bankers have a number of such opportunities pressing on their attention all the time, and the officers of the corporation may have to visit a number of bankers before they find one ready to undertake the financing required. A rejection of the proposal may not in the least indicate an unfavorable criti-

cism of the financing. Commitments of the banking house already made may sufficiently tie up the capital of the house and require the entire attention of the bankers.

Though people are familiar with the term "banker," as applied to these organizations for arranging long-time or relatively long-time commitments of capital, people are not generally familiar with the working of these banking houses. Bankers of the kind we are speaking of are termed "investment bankers" to distinguish them from commercial banks and bankers. Such investment bankers are engaged in financing relatively fixed capital; commercial bankers properly finance only circulating capital or capital in the course of consumption. People sometimes designate "investment bankers" as "private bankers," partly because they are not dealing with the public as generally as are the commercial banks, and partly because they more frequently do not incorporate, but do business as individuals and firms. Since in many of our States individuals and firms engaging in a commercial banking business, without taking out charters as national or state banks, are termed "private bankers," the term "private bankers," as applied to those people who finance relatively permanent capital, is not exclusive, besides not being as descriptive as

the term "investment banker." We use the term "banking house" in speaking of investment bankers rather than the term "bank," which we limit in our use to an organization acting under a charter, or at least to an organization which takes deposits.

Generally these banking houses are not incorporated. Though some have been incorporated in recent years, there is no noticeable tendency in the direction of incorporation. Usually partnerships of varying size, ranging from two to fifteen or sixteen partners, carry on the business. Some banks, more especially trust companies, have investment or bond departments which do the work of investment banking houses in every respect.

These banking houses vary a great deal in the range of work they undertake. Some occupy themselves exclusively, or almost exclusively, with municipal finance. Though they may get into other fields, they are likely to do so as brokers, or as a result of trading, or to carry some other kinds of securities to satisfy the needs of their clients. Such houses do not especially concern us. Other houses make the financing of public-service corporations, other than steam railroads, their principal interest. Even in the field of public utilities houses may specialize, as in the

securities of gas, or of electric light and power corporations, or in the securities of street railway corporations.

While speaking of houses chiefly interested in the financing of public service corporations, we should especially mention certain organizations which carry on together the work of engineering and operating concerns and financing houses. They both operate and supply the funds for the corporations they are interested in. Sometimes they originally did the engineering work for the construction of the corporations. Though such organizations are not numerous they are important. By reason of special skill and ability in their chosen fields they effect economies in operation and construction. They purchase plants which have not proved profitable under the existing management and through their special skill turn them into profitable enterprises. Through the magnitude of their operations they can also effect economies in the purchase of supplies. Such engineering-banking organizations specialize in the field of public utilities more than do bankers who are not also engineers. A house of engineering bankers confines itself to gas plants or to electric light properties or to street railways.

Other banking houses concern themselves

especially with financing the steam railroads. Only two or three have the necessary capital and financial connections to handle the largest issues of railroad securities. Railroads, however, often have smaller issues, as for the construction of branch lines or for the purchase of equipment, within the financial ability of ten or a dozen other houses, and commonly these other houses get the financing of such issues. Many houses which do not act directly as bankers for railroads, or seldom do so, still make railroad financing their principal interest by participating in underwriting transactions and acting as distributors of the securities. A good many banking houses have refused to go outside of these fields. They take the general ground that only a municipal bond, secured by the taxing power of some governmental agency, or a bond of a railway or other public service corporation, with its relative stability of earning power as pointed out in the chapter on "Trading on the Equity" in the first volume, afford the proper basis for safety. Further, under modern conditions these enterprises are relatively non-competitive. In spite of franchise difficulties they do not lie as open to attacks tending to a rapid destruction of values. Hence, that especially indeterminate element, the quality of the

management, though very important, does not assume the relative importance in a railroad or other public service enterprise as in an industrial undertaking. The general class of public service business makes it more subject to analysis and to the deduction of general principles than is the case with an industrial enterprise. Therefore the banker can formulate and apply tests from experience with a greater assurance that his judgment is sound. For these reasons many banking houses interested in the financing of corporations have refused to go outside of the public utility field. There is no reason why a banking house, recognizing the liability of industrial corporations to greater fluctuations in earnings, and in other ways the greater business risks involved, should not undertake the financing of industrial enterprises, and many do.

Besides differing in the kinds of corporation financing they undertake, these houses differ in other respects. Some take deposits from clients who purchase securities from them and from corporations for which they supply the funds for the capital account. Ordinarily these deposits, from the nature of the business, are individually of considerable size, and the banking house is otherwise not taking the place of a commercial

bank or a savings bank. A few of the banking houses have foreign exchange departments and, with respect to foreign trade transactions, conduct a banking business concerned only with the financing of commodities in the course of consumption.

Banking houses differ in the way they conduct their business as well as in the kinds of corporations they finance. Some do essentially a wholesale business. They assume the responsibility to the corporation, but, to a considerable extent, reach the ultimate consumer through some intermediary banking house. We will discuss the general manner in which they do this in a subsequent chapter on the syndicate operations of joint accounts and underwritings. Some houses take a larger part in the active trading on the street than other houses, to some extent speculate in bonds, and generally pay special attention to the needs of capitalists and financial institutions. To whatever extent these houses may act as distributors to the final consumer, the capitalists who ultimately supply the funds to the corporations, they usually initiate some of the business they do: that is, they are the only intermediary between the borrower and the lender. Though sometimes the only business they initiate is municipal, usually, if they really

enter the field of corporation finance at all, they finance directly the issues of the relatively smaller corporations and come in with the wholesalers on syndicate operations in the issues of the larger corporations.

From time to time some one expresses an unfavorable criticism of the profits made by investment bankers. Before proceeding to discuss this directly, let us consider the general nature of the business. Banking houses should be differentiated from brokerage houses. To use the language of the street, an investment banker deals on his own account, a broker deals only as agent. That is to say, an investment banker assumes the position of a merchant and buys and owns the securities he sells. In this respect he conducts his business like any merchant who keeps a stock of goods and counts on making a profit on the turnover. London officially classifies investment bankers as merchants and not as bankers. Though it is easy to make the analogy of the investment banker with a merchant carrying a stock of goods of securities, the analogy is not closely accurate. Though securities in their marketing possess many of the characteristics of goods in the process of consumption, they are not, of course, commodities in the same sense as are wheat and cotton. As a mer-

chant, the investment banker is more strictly like a buyer who goes round among many sheep-growers and buys wool in relatively small quantities, which in turn he sells to a few manufacturing concerns. So the investment banker buys capital from the grower, the capitalist who has accumulated savings, and sells the capital to the corporation. But the investment banker sells "short." He has already sold capital to the corporation in return for the corporation's credit, and has borrowed most of the capital to put with a little of his own to make delivery. He then proceeds to cover on his short sale of capital by buying from the capitalist with the credit with which the corporation paid for the capital from the banker. In using the word "credit" here, we do not confine it to its strict meaning of promise or obligation of the corporation, but include an interest in the corporation which may be represented by stock. From whatever angle we choose to view the business, the essential and important fact is that the investment banker assumes the risk of the transaction. Since the business is one of credit, which probably is more sensitive and fluctuates more widely and more quickly than any commodity prices, the assumption of risk in selling and buying capital, or buying and selling credit,

whichever way one chooses to look at the matter, means the assumption of a greater burden than that of the merchandising of ordinary commodities. A little later, when we are considering the amount of bankers' profits, we must keep in mind this fact of the assumption of risk. A broker, on the other hand, simply acts as intermediary between the buyer and seller for a commission and does not assume any risk of the market.

The total number of banking houses of this kind in the United States is not great. Of about 4000 offices, at the time of writing, in some way dealing in securities, practically all are brokerage offices of one kind or another. The membership of the Investment Bankers' Association of America includes most of the banking houses eligible for membership. Financial qualifications for membership are that the applicant shall be engaged in buying and selling securities on its own account and shall have a capital of at least \$50,000 engaged in this business. With a capital of less than \$50,000 a banking house could hardly enter the field of corporation finance in any way to deal directly with the corporation. At the time of writing the membership of the Association comprises 340 main offices and 176 branch offices of these houses. Practically the entire organ-

ized business of financing the capital account of our corporations centers in these houses. The total number of branch offices is undoubtedly much greater. The branch offices listed as members have, most of them, considerable autonomy in managing their affairs.

Probably most readers will be surprised that the amount of capital necessary to qualify for membership in the Investment Bankers' Association is so small rather than that it is so large. People are likely to assume from the magnitude of the transactions undertaken that the business must require the banking house to have a large capital. But the business does not require a large capital tied up in plant like a manufacturing organization. The investment banker is engaged in dealing in credit and requires capital only as an assistance in commanding credit. When the banker supplies the corporation with capital, he receives the corporation's securities at the same time. How much of the capital the banking house must advance itself and how much it can borrow on the transaction depend on the nature of the securities, the position, senior or junior, that they occupy in the corporation's plan of capitalization, and, especially, whether they are of a kind to command a relatively

quick and close market. Depending on these conditions the banker can borrow from 50 to 90 per cent of the money necessary to complete the transaction of purchasing the securities from the corporation. Though the loan will rarely be so small, in actual practice, as 50 per cent, the lender produces the same effect by insisting on mixed collateral and by accepting only a percentage of slow and wide market securities as collateral for a loan.

A reader entirely unfamiliar with financial transactions may wonder where the investment banker borrows the money. He borrows at any national bank, state bank, or trust company ready to undertake the business. Since the banks located in the financial districts naturally get the business of the dealers in securities, they come to be known as "financial banks." Instead of financing commodities in the course of consumption, they are, so to speak, financing securities in the course of consumption; that is, in the process of sale to the capitalists who commit their funds to the enterprise of the corporation issuing the securities. The bank in making the loan primarily considers the marketability of the securities put up as collateral. It is of the first importance to the bank that its loans should be liquid.

That is why, from the standpoint of a bank, it engages in the business of financing commodities in the course of consumption. As the commodities pass from one stage to another of the process of consumption, of marketing and use, the loans fall due and are repaid. If the bank can get an equally liquid loan in any other way it is just as good banking for it to do so. One danger lies in loaning on securities. Prices for the securities are very sensitive to credit and other market conditions and vary widely with general business conditions. Security prices fluctuate more widely than commodity prices. Panic conditions may make them not liquid at all. If the bank, however, takes as collateral securities with a quick market and watches the changes in price, it engages in thoroughly sound banking. The marketability of securities, however, varies widely, and ordinarily a bank would not require that all of its collateral for loans should have as quick a market as the most active stock exchange securities. The investment banker knows that he will have no difficulty in getting a loan on his active collateral. He wants to get accepted as collateral as many of his inactive securities as possible. Necessarily the investment banker must get some of his collateral released from time to time

as he proceeds with the sale of the securities, and substitute other securities in the place of those released. He may endeavor to get less active collateral accepted on these substitutions. If he meets with any success, the process is known by the expressive term of "milking the collateral."

The amount the bank will advance on the security of given collateral depends on the marketability of the collateral just discussed and on the possible or probable range of fluctuation in the market price. A bank would probably make a larger loan on the security of a good municipal bond than it would on the security of most very active high-grade railroad bonds. Though the municipal bond would not have as active a market as the railroad bond, the probable range of price fluctuation within a short time is not so great. In the same way a bank would not loan as much on stock collateral with the most active stock exchange market as it would on a well-secured bond with a good but much less active market. A bank might loan as much as 95 per cent of the market value of the very best municipal bonds and as much as 90 per cent of the market value of high-grade active railroad bonds, when it would not loan more than 75 per cent of the market value of an active stock. A bank

which makes a business of loaning on financial collateral of this kind must, of course, keep in the closest possible touch with the market for securities and watch the fluctuations in prices and their bearing on the loans of the institution.

We can now take up directly the statements of those who criticize the size of bankers' profits and who declare that they are an unwarranted charge on the community. Usually the critic accompanies his criticism with the advice that the corporations should seek their capital directly from the capitalist and cut out the banking-house middleman and its profits. We have already mentioned several reasons why the corporations are not successful when they attempt to do this, and have shown under what circumstances a corporation can, on appealing to its stockholders, get directly to the capitalist. Let us examine this charge of undue profits to the investment banker.

Such critics charge investment bankers with making a profit of two and a half per cent and sometimes as much as five or ten per cent. It is true that the difference between the price the banker pays for the securities and the price at which he expects to sell them does range from about one per cent to the higher figure charged against

them. The banking house bases its purchase price on its estimate of what it can sell the securities for. When the banker has decided on what price he can probably get for the securities, he offers the issuer a price of one point or more below this. The amount of difference he makes between his anticipated selling price and the price he offers to the issuer, he bases on the length of time the securities have to run, market conditions, and the probable amount of expense and labor involved in selling them. He can afford to make a smaller gross profit on short-time securities, not only because ordinarily they are easier to sell, but also because when they fall due he may have a chance to reinvest the fund and make another profit. Market conditions will influence him because, if they are stable, the transaction does not involve as much risk as when they are unstable; there is less chance that changing financial conditions will force him to sell at a lower price than he paid. If current interest rates are high, he will also have to take into consideration the possibility of loss on the interest account. Most of all, the probable difficulty of selling the securities will influence him. If they are of the kind which, however secure, will require a large amount of personal effort and consequently, under the

most favorable conditions, can be disposed of only from day to day over a considerable period of time, the banker will have to estimate a charge for the cost of selling, including the tying-up of his capital, and also for the risk of change in market conditions involved in the length of time necessary to complete the transaction.

Let us compare the profit the investment banker hopes to make with charges for service in other forms of financial work. Brokers in real estate mortgages make a minimum charge of one per cent for negotiating the highest grade of real estate mortgages on New York City property. Such mortgages as they will handle on a one per cent commission are a legal investment for New York savings banks.

When dealing in bonds that are a legal savings bank investment, the investment banker, acting only as a broker in the transaction, often charges as little as one sixteenth of one per cent and sometimes only one thirty-second of one per cent. The usual commission for selling securities of this character is one eighth of one per cent, or \$1.25 per \$1000 bond.

If a mortgage on improved property in New York City exceeds in the slightest degree three fifths of the appraised value of

the property, it is not a legal investment for the savings banks. For mortgages which do not fall within the savings bank class the broker immediately advances his rate of commission to two per cent or more. His risk is not increased, for he assumes no risk or responsibility. He does not buy the security as does an investment banker the securities he deals in. The mortgage broker charges the increased commission because he finds it harder work to locate a buyer for a mortgage which does not fall within the legal limitations of a savings bank investment. There is a broad market for investments within the savings bank class and it is not difficult to convince an investor of the merits of such a security.

The difference between these two rates of commission does not express the full situation. The mortgage may run for only three years, the bond for thirty years. When the mortgage falls due, it may be paid off. Then the broker will have another chance to make a commission on selling the investor a new mortgage. But the bond broker may not for thirty years have an opportunity to reinvest for his client the capital placed in bonds. Investment bankers are fully aware of the value to them of more frequent periods in the investment of capital and are glad to

handle short-term securities, one maturing, say, in three or five years, on a smaller anticipation of profit than that sought for handling a long-term bond.

Dealers in commercial paper, which runs from thirty to ninety days, receive a regular commission of one quarter of one per cent for selling it. Allowing for only the longest maturities the fund is reinvested four times a year, giving the note broker, if he is fortunate enough to command the reinvestment each time, an opportunity to make one per cent a year out of a given fund of capital.

Both these commissions — that of the mortgage broker and that of the note broker — are only for the work of locating the capital and inducing the capitalist to make the commitment. Note brokers sell almost entirely to banks, and each transaction reaches an amount of some magnitude. The high-grade real estate mortgage, although usually having only a local market, is a well-known security in its market. On account of certain market disadvantages, the uneven denominations, and the fact that no two mortgages are exactly alike, the work of selling is greater than the work of selling the most active bonds. It is not nearly so great as the work of persuading a capitalist to commit his funds to a relatively unknown though a thoroughly sound enterprise.

More than any other merchant the investment dealer assumes a moral responsibility for the goods he sells, irrespective of their grade. A dealer in merchandise is not expected to guarantee the wear of his goods unless he represents them to be of the best class. Though a merchant in investment securities does not represent everything that he sells to be as safe as government bonds, those who buy from him are disposed to hold him responsible if the investment proves unprofitable and the interest and principal are not paid promptly. A default is a severe blow to his prestige and to the confidence in his judgment, by virtue of which he holds his clientèle.

These facts justify the profits that the investment merchant is accused of making. The larger differences between buying and selling price are a consideration for the difficulties of the business. The credit of corporations varies widely, as does the market for their obligations. Thousands of people know the value of the Pennsylvania Railroad's promise to pay and need no persuasion to buy its securities. Few people know the value of a similar obligation made by an electric light company in some small city of a remote State. Though the security may seem safe to those who are experts, the larger public has to be convinced of it.

Each investor to whom such securities are offered must be persuaded to believe in them. It may take a year of negotiation to induce him to buy. Bond salesmen have often found it necessary to wait as long as that to sell good but slow paper.

Meanwhile, the dealer's capital is tied up in the bonds he has bought and his money is being spent to convince the investor. The purchase and resale of securities which, though good, are but little known, involves more capital, time, labor, and risk than are required for the purchase of standard securities that always command a market, and it is altogether reasonable that such operations should pay a larger profit.

If the investment merchant were unwilling to undertake this more hazardous and laborious sort of business, the small municipalities in Western States might have to do without their transportation or lights, or to get them at a higher cost. Such communities are without the capital required for their development, or, if it can be locally obtained, the cost would be higher than that at which it can be procured in the financial centers. The dealer is paid for making a market and for the cost of the selling; he does not in any way deceive the purchaser.

The investor does not expect, and knows

that he is not purchasing, a security immediately salable through any other channel than that through which he bought it. Usually the dealer stands ready in case of need to repurchase the securities so sold at a reasonable concession. High standards prevail in this business. In comparison with the work done and the responsibilities assumed, the charges are moderate.

Though it is admitted that there is risk in the merchandising of securities, also it should be admitted that often there is actual loss. With all the experience and skill the merchant can bring to bear on his purchases, the conditions under which he works are so complex that he often cannot foresee the outcome. If the hoped-for per cent of profit is not made, the transaction may turn to the loss of many per cent, besides the cost of selling. If a dealer has not been shrewd enough to sell out in advance of falling prices, or does not gauge accurately the duration and rapidity of the decline, he may take heavy losses. Probably no investment banker went through the transition, from the period of rising security prices culminating in 1905 to the subsequent period of declining prices and the panic of 1907, without taking large losses. Bonds bought in the hope of selling at three fourths of one per

cent above the purchase price were sold at a loss of from four to five per cent. Except in the case of specialty bonds sold through a careful education of the investor in the merits of the particular security, a sale in a declining market must be practically immediate in order to be really profitable. If a dealer misjudges the appetite of purchasers, he gets "hung up" with an issue of securities which the investor will not even masticate, to say nothing of digesting.

A closing-up of the market, the refusal of investors to purchase, is a common, periodic phenomenon, which becomes particularly acute in London. It takes place whenever investors generally think the present is not a good time to buy. If an investment merchant fails to foresee its coming, he has to carry a heavy burden of securities that he cannot sell. Security selling differs from other selling in that purchasers are under less pressure to buy. People must eat — must buy from the grocer. Clothes wear out and the tailor must be seen. No such necessities help the seller of securities. Capital can linger in the bank for months, until enticed by lower prices or driven out by fear of higher.

Any one not familiar with the facts would infer that an investment merchant's great-

est difficulty is in finding securities to buy. That is not the case. Goods are pressed on him as on any other merchant. Day after day promoters, new and old, cool their heels in his anteroom. Out of the many things offered him, which is the best for his clients? Which is most likely from subsequent success to enlarge his reputation as a merchant and further that confidence forming the very life of his business? A corporation manager without an established connection with some security-selling house is likely to have a weary time when he wants to place an issue. His securities may be good and in every way merit confidence. But the pressure to get access to the capital supply is enormous. A given merchant may much desire to take on the business, but he is already so largely committed that he could not sell any more securities if he should buy them. The corporation manager may have to visit many merchants and wait a long time before he can find a buyer. This situation does not arise through any unfair discrimination. The capital supply is a very limited one. The capital demand exceeds it and absorbs it as the sand of the desert absorbs rain.

Contrary to the general idea, the business of investment banking is highly competitive. This results from the comparative

ease with which the investment banker may borrow a large part of his capital for certain kinds of transactions. Probably he does not stand in any better position in this respect than does the merchant in fairly standard commodities, who can do business from rented offices and salesrooms 'and borrow money with which to carry his merchandise. He does occupy a better position than most manufacturers, who, to be sure, may be able to finance their commodity in the case of production readily enough, but who must usually have a large capital invested in plant, on which they can borrow, and that with difficulty, perhaps one third.

As we have seen, a capital of \$50,000 used in the purchase and sale of securities fulfills the capital requirement for membership in the national organization of the Investment Bankers' Association. Though so small a capital will limit the classes of business a new organization can engage in, it will enable men with the necessary professional experience to enter the business on their own account. Constantly men who have acquired the training in one of the older houses organize their own houses and start in for themselves. If a man has demonstrated his ability to place securities, — that is, to induce investors to commit their capital to the par-

ticular enterprises whose securities he has to sell, — and has proved himself a success in this branch of the business, — even though he has no capital himself, he may be able to persuade some one with capital to join him in organizing a new banking house. He has established a clientèle. Some of his clients have dealt with him mainly because of the house he represented, but many, and very likely the much larger number, have dealt with him because of personal liking or because of personal confidence in him. Such a connection is a valuable asset for the new house and the nucleus for the most valuable asset of any house, — a well-established clientèle, a list of capitalists who do most and perhaps all of their investing through the house.

Some of the older banking houses have become parents in this way of several new banking houses, in one case of possibly a score. The general process is no different from the process in other kinds of business, but easier than in some, and the relative ease of the starting of new organizations makes the competition for the good-will of capitalists very keen and extends the number of organizations to which a corporation may appeal when in need of new funds for the capital account.

Referring especially to the relationship between the banking houses and the corporations, accusations have been made in recent years of a money trust. ~~In these charges it~~ has been said that corporations could procure funds only through the good-will of certain financial interests and, if these interests were not well disposed, the corporation could not get help anywhere. It is true that the capital requirements of some of our largest corporations are so great that probably only one or two banking houses, or groups of financial interests, have the financial strength to handle them, and the corporation therefore cannot be financed without the assistance of one of these financial groups. A concentration of control over capital has been necessary to meet the magnitude of the requirements of modern business. If any smaller enterprise were likely to be a thorn in the flesh of one of these big business undertakings, the banking connections of these undertakings perhaps might make it difficult for the smaller enterprise to get financial backing. Business is competitive and the methods of competition extend into the financial as well as into other business fields.

Probably it is a fair generalization to say that, with the exception of the very largest corporations which are limited for the rea-

son just given, any corporation has at least several entirely independent and competitive banking houses to which it may appeal for financial support. The business of financing our medium-sized corporations is an open field and no favors. Our smaller industrial enterprises find difficulty in getting capital on account of their very smallness. A banking house must do a large amount of work in making a corporation well enough known to capitalists for them even to give consideration to its securities. It takes even more work to make the small corporation known than the large one. The large corporation has already advertised itself. It is impracticable to build up a course of dealings in the securities of small corporations which will give them the valuable element of marketability. With all the work involved the possible profits in providing \$100,000 of capital for a small corporation will not compensate a banking house for its preliminary labor: especially if the banking house is organized to handle issues of a larger size.

Banking houses have overcome much of the difficulty of financing small corporations in the case of public service enterprises. Because of the more nearly uniform nature of the business the bankers do not have to do as much "educating" of the capitalist. He

knows the general nature of the business and the kind of risks involved. Each industrial enterprise is more nearly a law unto itself. Banking houses have developed some special methods of financing the public service corporations. The holding company and the engineer bankers operating a series of properties all help in the financing of the relatively small public service corporation. So the small public utility gets financed and the small industrial enterprise goes begging.

We have wandered somewhat away from the matter of the accusations of the existence of a money trust. Some of the accusations doubtless originate with those in control of enterprises, either under way or in the course of promotion, who have had no experience with the demands of capitalists. Many people of this kind come to the "street" to raise capital and do not succeed. They charge their failure to the money trust, which for some reason does not wish them to succeed. As a matter of fact their proposals are probably of a kind no banking house could handle. Many come with promotion projects and . . . these, however meritorious, do not interest most banking houses. Some actually are meritorious yet, because they are in the promotion stage, cannot get a hearing. Many are not meritorious, yet the promoter feels

confident of his judgment and charges up to the malevolence of the money trust a failure which results from the class of his business and its demerits within that class.

Managers of going concerns, who have not had occasion before to appeal to the banking houses, come to the street with proposals impossible of acceptance. Until they are educated in the requirements of the bankers, — which means, in the last analysis, the requirements of capitalists who will ultimately advance the funds, — these managers will blame the money trust for the non-acceptance of their proposals. The most important and the most general reason for the inability of many of these corporation managers to get funds is the simple fact that there is not money enough to go round.

For every dollar of capital in existence a multitude of people are seeking a dollar to further their interests. The demand for capital is unlimited, provided the terms are not too unfavorable, and the supply of capital is strictly limited on any terms whatever. An insistence that the risk be not too great is most likely to be that part of the terms which the seeker for capital cannot meet. Out of a hundred people seeking capital the capitalist will supply it to that one who will offer the most favorable terms, the

best bargain in risk, income, and control. The investment banker acts for the capitalist, and will commit himself to that enterprise which he believes most likely, under existing conditions, to meet with the favor of the capitalist, in view of other opportunities for commitment which other banking houses are offering. The man who comes to the street for funds, however, does not see the pressure of all the other enterprises seeking capital. If he did see the pressure, he probably would consider the enterprises all inferior to his own. He even regards those enterprises which are financed as inferior to the one dear to him. His preference for his own is natural. But it leaves him with no reason for the banker's rejection but the machinations of the money trust.

Some get confirmed in their impression of monopoly by certain aspects of the ethics of the investment banking business, which are unfamiliar to them. It is a general principle of investment bankers to decline to consider a proposal for financing while it is before another house. As soon as one house rejects it, then another house feels free to take it up. This aspect of the business has something in it of the ethics of the lawyer and the physician, in refusing to take away the client or patient of another member of

the profession. It does not, however, have the full foundation of injury to the client's interests and to professional reputation existing in the case of the lawyer and physician. Besides this matter of professional feeling, a banking house does not want to spend its time considering a piece of business which, before it can arrive at a conclusion, may be taken care of elsewhere. The ethics of the situation serves to protect the banker's time. To be sure, it equally serves to cause delay to the man seeking capital. But in determining which one is to occupy the better position in this respect, the banker has the advantage in the number of enterprises which are constantly pressed upon his attention. Besides, the existing disposition of the situation settles it the right way in the end. If several people are considering a piece of business at the same time, all but one of them are bound to do their work fruitlessly. Though the limitation to one at a time delays the seeker for capital, it greatly lessens the amount of useless work in the world.

Some people who come to the street for money, without especially knowing the banker's ethics of the situation, have themselves an ethics of business which prevents them from taking their proposal to more than one banker at a time. Others, who chafe under

the restriction, nevertheless know the un-wisdom of trying to avoid it. Frequently, however, men come to the street whose own ideas of business include making as many proposals as possible and closing with the first one who will come to terms. When the fact that they are dealing with several people comes to the attention of one of the several, as it probably will, that one is likely to decline further negotiations, and so with the others as they find out the situation. So the man who is seeking the funds gets an idea of monopoly, that a money trust exists.

Let us assume that our banking house has made an agreement with the corporation to supply it with funds on the delivery of the issue of securities which the corporation has authorized. If the amount involved is so great that the banking house does not care to assume the entire risk of the transaction, it will have distributed the risk by getting one or more other houses to join it in the transaction. To use the language of the street, it will have formed a "joint account," and the other houses will have taken a "participation" in the account. Later the banking house which initiated the joint account, or the several members of the account acting together, may still further distribute the risk by arranging an underwriting syndicate.

This, however, will not be formed until after the securities are purchased, or until at least a binding agreement to purchase them has been made. One banking house may form the joint account in anticipation of committing itself to the purchase. Though simple enough in the idea of distribution of risk, in details these joint accounts are somewhat complicated transactions. We will take a fuller discussion of them for our next topic.

As soon as the banking house has definitely contracted to purchase an issue of securities, it will begin to plan for its sale. It is not an investment institution like an insurance company or a savings bank, but employs its capital and organization simply as a means of assuming the risk of the transaction and of establishing the direct connection between the corporation and the body of capitalists who will ultimately be supplying its fixed capital requirements. In pursuance of this end the banking house may make a formal public offering inviting capitalists to subscribe to the issue, or it may undertake to sell the bonds without a formal public offering. This statement does not mean that in either case the banking house will not publicly advertise the securities, but rather distinguishes between the manner of advertising. If the banking house, or syndi-

cate, extends a formal invitation to subscribe, it will say in so many words that it is offering the securities for sale and will receive subscriptions at the price named up to the stated hour of the stated day.

Such an advertisement does not mean that the banking house is relying upon it to interest enough capitalists to take up the entire issue. It does not even mean that it has an expectation, or hope, that it will interest a large enough number of capitalists to place the entire issue. More probably the house, or the syndicate of several houses, has been hard at work creating an interest in the issue for a considerable time before the advertisement appears. The house may have informed its clients by personal interview or by letter that such an issue would be brought out. Its salesmen may have quietly, but rather busily, talked it up for a number of weeks. Just before the house inserted the advertisement in the newspapers it probably sent circulars to all its clients containing the information about the issue and inviting subscriptions. The advertisement appearing in the newspapers, in all probability, simply focuses this anticipatory work. The banking house or syndicate does hope that the issue will prove sufficiently popular to attract enough people, other than regular

clients, to make a demand that will take up the issue or materially diminish the amount that will remain unsold. If the issue is highly successful, the house may stop taking subscriptions even before the day and hour announced in its advertisement. In that event it will announce that the issue was oversubscribed and the books closed at the time stated. Such a procedure gives the regular clients of the house an opportunity to get the full amount they have subscribed for, or near to it, and leaves unsatisfied a demand on the part of many, who may seek to purchase the bonds in the open market at a price higher than the subscription price; thus giving the regular clients an opportunity to make something immediately on a resale, if they wish to do so, or to feel that they have made a highly advantageous purchase. Closing the books before the announced time may also be taken by the investing public to be a better indication that an issue actually has been oversubscribed, than an announcement to that effect when the books have been kept open for the full time advertised.

It seems rather the better practice, however, to allow the full length of time announced. Many people who want to subscribe may interpret the announcement that the books will be closed by the stated time

as meaning that they will remain open till that time, and some regular clients of the house may be among that number. The house is at full liberty to prefer its own regular clients in making an allotment of the securities. Subscriptions of such a character that the house would favor them may be late in coming in. The extra work involved in handling an actual large oversubscription hardly offsets the various reasons for keeping the subscription book open.

Of course it is undesirable, from the market point of view, that an impression should get out that the offering was not wholly successful. Undoubtedly banking houses often announce that an issue was fully subscribed for or oversubscribed, when that is, at best, only technically the case. Some subsidiary organization of the banking house may have put in a "subscription" large enough to provide for the amount not really, as well as technically, subscribed for; or another joint account may have been formed to "subscribe" for and take over the bonds. Since the possible use of such subterfuges is well known in the street, an announcement of an oversubscription is likely to be taken with a grain of salt unless there is corroborative evidence. The future conduct of the market, the course of prices in the particular

security, may indicate that the announcement is really true. On the other hand, if the original offering house, or even another house, appears to be offering the bonds in substantial amounts or with a degree of continuity, people in the street surmise that the oversubscription announcement may have been made with a mental reservation.

Such a formal advertisement for subscriptions is more likely to be made of the larger than of the smaller issues. In the case of most issues the banking houses are more likely to advertise the issue for sale without stating formally that subscriptions will be received and the books closed at a definite time. If the house advertises that the books will be closed at a certain time, it draws attention to that time and causes an expectation that it will make some announcement of the favor with which the issue is received. In the event that investors do not fully take up the issue the banking house faces the dilemma of being obliged to resort to some subterfuge, or of having emphasized the lack of the complete immediate success of the issue. If it simply advertises the securities for sale, it can announce that they have all been sold; if the public fails to take all the securities at once, it does not have to say anything. When the banking house takes

the position of an underwriter to the issuing corporation, it offers the securities for sale on behalf of the corporation. The transaction will need to take the form of a subscription, with bankers bound to take up and pay for any part of the issue remaining unsold. Often, especially in the case of small issues, the banking house does not advertise the issue in the public press at all.

After the banking house has presented its advertisement in the public press, and the "public" has failed to purchase all of the securities, the house faces the second and difficult part of its selling problem. It must dispose of the rest of the issue by the much slower process of convincing capitalists, not in the mass but one at a time, of the merits of the security and that it is a good bargain at the price. It will do this largely through the efforts of its salesmen. Probably Jay Cooke first showed the power of salesmen in the marketing of securities. He succeeded, by the use of salesmen and extensive advertising in other ways, in raising the large sums required by the North for the Civil War. Cooke's salesmen did not form part of a distinct profession like that of the securities salesmen of to-day. It did not require a wide comparative knowledge of securities and of financial conditions and

methods to offer bonds of the United States Government. The selling of Civil War issues was a big canvassing campaign conducted in much the same way and by much the same kind of people as book canvassing. It demonstrated, however, that personal contact is as powerful in the selling of securities as in any other kind of selling. Though the modern investment banking house with its force of salesmen did not develop at once as a result of Jay Cooke's example, the men who now go out to meet the capitalist in his office have formed a well-recognized class for a generation.

* Banking houses recruit their force of salesmen from various sources. Sometimes the men have been successful in selling of other kinds and have looked to the investment banking business as of a higher grade. They may come from almost any other occupation. The tendency in recent years has been for a house to train its own salesmen and ✓ for the most part to recruit its apprentices ✓ from recent graduates of colleges. It will take such young men into its offices, giving them a little guidance to sources of information about corporations and investment banking matters. Occasionally the manager or office employees of the house will set them to some office task. Though some houses

give them a measure of regular instruction, for the most part they leave them a good deal to their own resources to acquire an understanding of what is going on about them and a knowledge of securities. Some houses will not keep them at this for more than three months before letting them go out of the office to make their first efforts at selling; other houses will keep them in the office for two or three years. They are essentially in the position of students during this period and receive only nominal compensation for nominal services. The difference in the time of this part of the apprenticeship required by different houses depends on varying ideas about the minimum of financial matters a man ought to know before he should be permitted to approach a possible and prospective client.

Though the banking house picks these young men with an eye to their probable capacity for the work they are to undertake, the employer finds it difficult to say which of those he has chosen will succeed in selling and which will fail. When they are permitted to go out and seek the capitalist face to face, they have a difficult task ahead of them. Naturally the house does not entrust them during this apprentice period with any well-developed territory. So they must for

the most part first discover the capitalist. They will not have any great difficulty in identifying the capitalists in the smaller communities and in securing at least a brief interview with them. But competitors find it equally easy to learn of the capitalist members of the small communities and to gain access to them. In the larger communities the problem of finding the capitalists at all is much harder. Since the number of substantial capitalists in any community is necessarily a small percentage of the inhabitants, a canvass of the entire population is obviously impracticable. To describe some of the many devices to locate them would extend this discussion unduly.

The reader will, of course, see that not all capitalists are available material for the securities salesmen to work on. Most men owning, and actively engaged in, their own business use all their capital in it. Of active business men only those who have a surplus to invest outside of their own business can take any part in furnishing funds to those corporations which look to the general investing public for supplying their capital account. Those business men who do have surplus funds for investment, and those capitalists who are not actively engaged in a business of their own, may not invest all or

any of their capital in the financing of corporations. Ownership and improvement of real estate require financing as well as corporate enterprises. A large proportion of capitalists with surplus funds, on which they do not want to accept the risk of unprotected ownership, invest in ordinary realty mortgages,—rural mortgages if they live in the country, or in close association with the country, and urban mortgages if they live in the city.

Under most circumstances it is natural for the man with surplus funds to turn first to the ordinary real estate mortgage for investment. It offers the simplest form of security. Though some people begin to suspect that investment in real estate mortgages is a more complex matter and more worthy of analysis than investors have commonly thought, involving, as it does, the whole problem of shifting realty values and economic rent, on the surface it is much simpler than what, to the novice in investment, is the labyrinth of corporate securities, with their finely differentiated gradations of risk, income, and control and all the intricacies of business income. Moreover, people who invest in mortgages for the most part invest locally. They can see the tangible property in which their funds are invested. The mat-

ter has a degree of reality about it which an investment represented by a piece of corporation paper does not possess. All these considerations incline the man getting his first experience in investing to select the ordinary real estate mortgage. Many capitalists all their lives adhere exclusively to this form of investment.

So our young bond salesman will find that he not only has the task of finding capitalists, but of finding that selection of investors among the class of capitalists whom he can interest in financing corporations. When he has found a man whom he knows to be an investor, and whom he knows as willing to consider an investment in corporation securities, he has only begun his selling task. Only the very wealthiest of capitalists are wealthy enough to have funds to invest at almost any time. Our salesman must, in the first place, command the confidence of the capitalist. A reasonably cautious man does not invest a thousand dollars or more through an entire stranger. Our salesman cannot reasonably expect to do business until the capitalist feels acquainted with him and has formed a good opinion of him. Even though the capitalist may be thoroughly familiar with the name of the banking house which the salesman represents, and knows

that it is a house of the highest reputation, he will still want to feel personally well acquainted with the salesman. Investing is too intimate a business to transact with, or through, a stranger. After the salesman and the capitalist have reached the degree of acquaintanceship at which the capitalist is willing to make an investment through the salesman, our young man may still have to wait a long time before the capitalist is in funds and ready to invest. So our young salesman will not be likely to put through many transactions during his first few months of work in the endeavor.

When the salesman has once put through a piece of business with an investor, he has made a client, for a man who has money to invest at one time will probably have money to invest at another time. Even if the investor lives up to his full income, he will probably have some investments maturing, part of his capital paid back from time to time. If our salesman has grit to stick to the work, energy and resourcefulness in prosecuting it, he will gradually build up a clientèle which will be as valuable an asset to him as the clientèle of any professional man. But after all, this aspect of the selling problem of banking houses does not differ greatly from selling through a personal representative in any kind of business.

When most young men first entertain the idea of selling securities, they think of visiting financial institutions, especially of calling at the banks. In the largest financial centers some salesmen, who have developed in that direction and to that point, do confine themselves largely to the financial institutions. Outside of the largest centers, and even in those centers except for the specialized salesmen, selling to these institutions will form only a small part of the work of the bond salesman. In the first place, selling to them at all must depend upon having available to offer the kind of securities they buy. If the salesman is approaching the investing officer of a savings bank or an insurance company, he must be able to offer securities in which they may legally invest. If he is endeavoring to sell to an ordinary bank of deposit, he probably will not have a chance of success unless he is offering some very active market security protected by an equity. Some trust companies, acting more in the capacity of savings banks than of commercial banks and, outside of the States in which the savings bank is well developed as a financial institution, some national and state banks which people use much as savings banks, may invest to some extent in relatively slow market securities. Some of these banks un-

doubtedly go too far in this direction: for any security which is a legal investment for savings banks in the important savings banks States enjoys a rather ready market.

Institutional business of this kind is much more highly competitive than selling to private investors. The personal relationship of the salesman and the purchaser is not so important. The institution will buy from any salesman who offers, at a time when it is in funds for investment, securities which are of a kind and at a price to make them the best offering presented. The fact that an institution once buys from a particular salesman does not carry any probability that the next time it has funds to invest it will invest them through the same salesman. It makes a regular business of buying. Most capitalists make the business of investing only an incidental matter. They are much more likely to rely on one or, at most, a few salesmen through whom to make their commitments. It is the list of private investors, who are clients of a banking house, that furnishes the best foundation for financial strength.

Salesmen for the banking houses vary in quality. Some have little knowledge of securities or skill in salesmanship and are hardly more than canvassers, but they never-

theless succeed in doing some selling. From the low level they grade up to men expert in salesmanship and often having an extended knowledge of financial matters. These higher grade men achieve a good professional standard and become real financial advisers to their clients.

Most banking houses have a simple organization. If the organization is complex, it is so because of activities other than those strictly of the investment banker. Commercial loans, foreign exchange, engineering and operating departments, outside of the business of finding funds for municipal and private corporations, sometimes extend the scope of the banking house to that of a complex concern. In the house that confines itself to dealing in securities, the work of any one man may take him into all the fields covered by the work of the house. Usually an investment banking organization makes at least four general divisions of the work — the selling, the buying, the statistical, and the cashier's departments.

We have already discussed the work of the bond salesman in selling. The work of the sales department looms large in the banking house as in any other merchandising organization. The buying department may buy only if the selling department can sell.

On the other hand, it is as true of the securities business as of any other that goods well bought are half sold. In the office a member of the firm, or a sales manager, will have charge of the selling. It will be his duty, and, if the house is one of some magnitude, that of his office assistants, to keep closely in touch with the salesman. They may send the salesman a daily letter of information and advice. They will write letters at the request of the salesman and of their own initiative to clients of the house. Usually the salesman will send in daily reports of his work. These reports contain information the salesman has gathered about the needs and holdings of his clients. From these reports the office organization makes a record of such matters as when the client is likely to be in funds for investment, what kinds of securities he will invest in, and the names of any securities the salesman may have learned that he already owns.

When clients feel complete confidence in their banking house as really an expert adviser in financial matters, they will sometimes voluntarily give the salesman a complete list of their securities. In some cases the client has made his first and all subsequent commitments with the banking house and the house has a record of all his holdings as a

matter of course. Such information is valuable to the house. From the investor's standpoint it is desirable that the house should have it. As a result of having this information the banking house can often advise him of possible advantageous changes in investments. Though possession of this information may offer a temptation to the banking house to suggest changes disadvantageous to the client, considering all his circumstances, for the sake of stimulating business, the house, looking forward to its best interests in the long run, will not suggest them. The better the client's financial affairs prosper under the advice of the bankers, the closer the client's business attachment to the banker and the less chance some competitor has to win away his allegiance.

It is part of the duty of the office sales organization to keep the mailing list revised to include all live prospects and to exclude all dead ones. The house does not confine its mailing list to those whom it may count as its clients because it has actually done business with them, but wants on the list the names of all people to whom it is worth while for that house to send its circulars describing the securities it has for sale.

In all these matters of selling, the banking house does not differ widely from any selling

organization. One aspect of its selling, however, is especially important. Its supply of any one issue of securities is limited, and it must not sell any more of a particular issue than it can deliver. To avoid getting into an embarrassing situation the salesmen must make all sales subject to confirmation from the office and promptly notify the office by telephone or telegram of any sale. The same prompt notification must be given as between the main office and the various branch offices, so that each may know at all times the balance of any particular issue available for sale.

We shall have something to say at another place about the work of the banking houses in buying and will only mention it here. Some houses are large enough to have experts in their own employ for the investigation of properties the financing of which they are considering. The fact that a house has its own engineer and its own lawyer does not mean that it does not also employ outside experts, but only that the expert employees make the preliminary investigations and the house retains the independent professional men for final reports only after its own men have made favorable preliminary reports. Undoubtedly the buying depends upon the selling. What will investors pur-

chase under existing conditions and what price will they pay? The answer to these questions supplies the guide to the buying. Those members of the banking organization in charge of the buying must keep in the closest possible touch with those in charge of the selling. Nevertheless, banking houses can and do accomplish much in educating capitalists in investment. They constantly educate them in types of securities, and in kinds of enterprises. Though they follow, they to some extent shape, the demand for securities. This is to say that, to a considerable extent, they decide what enterprises can most advantageously use new capital. In this way they do largely direct the flow of capital into industry and exert a strong influence upon the economic life of the community.

The name alone of the "statistical department" largely describes it. It serves both the buying and the selling sides of the banking organization with statistical information. It prepares the circulars for use in the selling; and the preparation of a good circular, one that will not unduly emphasize either the good or the bad aspects of a security, one that will be honest yet a good selling circular, requires excellent judgment. A cautious house will submit its circular to the attorneys who acted on the legal side of the

issue to be sure that it does not contain any unintentional misrepresentation of the legal aspects of the security. The responsibility of a banking house for what appears on its circulars goes far. In a rather well-known case the dealers in a security were held liable for a representation on a circular, made in good faith on the opinion of eminent counsel, that the legal situation was as stated, when afterwards the courts held that the opinion of counsel was a mistaken one. Clients constantly make inquiries of banking houses about the market standing and intrinsic value of particular securities. The statistical department looks up all matters of this kind; and in general it is the duty of the department to supply all the people in the organization with information about securities.

To assist it in its duties the statistical department will have at hand up-to-date copies of the various financial manuals and of the *Commercial and Financial Chronicle*, all running back at least as far as to the time of the organization of the house. It is somewhat the insignia of honor to have the bound volumes of the *Chronicle*, as the standard weekly periodical of the business is known, running back to the first volume. The department will probably have also other finan-

cial periodicals. It will take an information service, by which up-to-date information of earnings and other facts will be supplied on printed cards, to file and serve as a supplement to the information in the manuals and keep them up to the latest news. It may somewhat extensively clip and keep on file information coming out generally in the press. It will collect and file for reference the circulars through which other houses advertise their securities. It will gather copies of mortgages and trust deeds and other legal documents, which are the original "sources" of much of the information about securities. Since these documents are regularly printed, it is not difficult to get them when they first come out, on application to the house bringing out the issue. Afterwards they are hard to get and quick access thereto is often wanted.

The cashier's department keeps the accounts and records of the banking house; attends to receiving, paying for, delivering, and collecting payment for, securities that pass through the organization. It also has charge of the loans from the banks and the collateral deposited to secure them. The partners will have attended to the bank connections of the house and to the more important matters in connection with arrang-

ing the loans, but the cashier's department attends to all details. In making deliveries of securities to out-of-town clients the cashier will usually, on the instructions of the client, send them by registered mail, insured, to a designated bank with draft attached. Unless the client gives contrary instructions, however, the cashier may estimate whether it may not be cheaper to deliver the securities by an express company, in which case the express company is the insurer. The cashier's department will have to compute all accruals of interest, and all other matters of price and "bases" of true income on all purchases and sales, whether the purchases are of the issue from the corporation or of securities from a client.

During the process of distributing securities the bankers must support the market. After they have sold the securities they must make a market for them, so far as the nature of the issue permits. We will discuss later the matter of listing securities on the stock exchange. If the bankers, while they have any part of an issue to sell, should permit quotations at prices less than their offering price, on the exchange or off the exchange, —for hardly anything in the way of a transaction fails to become known on the street, —it will become impossible for them to dis-

pose of the securities. Of course no one will pay the bankers their price for the security if it can be bought from some one else at a lower price. While the bankers are selling an issue they must keep the market clean of the security, and must be careful in their selling to place securities where they are not likely, for the time being, at least, to be offered in the market.

The banker will prefer the small investor in making sales to this end of keeping securities off the market. If the securities are offered publicly and are oversubscribed, the bankers will allot small subscribers all of the security they subscribe for, or a proportionally greater part than the large subscriber, and the allotment of the large subscriber will be proportionally cut down. The small subscriber is more likely to be an investor, or, stated the other way, the large subscriber is more likely to be a speculator simply hoping to make a market turn on the possibility of an oversubscription, and intending to put his securities right back into the market, whatever happens.

We should remember that since the market in listed stocks is on the exchange, and practically no dealings take place in them off the exchange, then in building up a market in a stock the banker will especially have

to watch the exchange. The market will be largely off the exchange in other securities, whether listed or not. When building up a market in such securities the banker will enlist the interest of brokers who are not connected with the stock exchange, and of smaller dealers whose clients may want to purchase some of this particular issue, but who would prefer to purchase through their regular dealer. Through allowing such brokers and dealers a commission, though only a quarter of a point, for purchases or subscriptions through them, the bankers stimulate their interest in the issue. Once such a dealer or broker has handled the security for some of his clients he feels something of an interest in the security, and may go on recommending it or offering to deal in it. Interest of this kind will prove very useful in working up a really active market.

In underwriting syndicates bankers lay a much stronger substructure for a market. Through them, many other banking houses are interested with that vital interest arising out of a financial stake in the transaction. Every one of them becomes in some degree a trading post for the security thereafter. Usually these syndicates are thought of only as a means of getting sufficient distributing power to dispose of the issue in the first

instance. They are also highly important as a base for that trading which makes an active market and gives an issue that valuable quality of marketability.

When a banking house has disposed of an issue, it will not drop the matter entirely and turn its attention absolutely to other matters. For the sake of its own clients it must maintain a trading position in the security. Though these clients may have had no thought but investment at the time they bought the securities, situations will arise which, without any prior thought of speculation, will require some of these clients to sell. In such circumstances the bankers will have to be ready to take the securities off the hands of the client or else lose his good-will. Unless the bankers have built up a trading market with known quotations, they will have to pay, in order to satisfy the client, a price somewhere near the price at which he bought the securities, even though financial conditions are such that all securities have suffered in their market value for causes quite outside the issuing corporation. If the security has had a regular course of dealings with known quotations, the client is more likely to have drawn his own conclusions. In any event, he knows that he cannot get more than the market price. So, for

their own protection, the satisfaction of their clientèle, and for their general reputation, the bankers will endeavor to build up a course of dealings in any issue of large enough size to make a market really possible.

In building up such a market the bankers perform a service of value to the corporation for future issues. The dealings constantly advertise the corporation. Its outstanding securities sell at a higher price because of their marketability. Quotations for outstanding securities make the basis for estimating what their new issues will command. One should take these facts into account when considering the value of the work the bankers do.

Since we shall not discuss the nature of the market off the exchange as a special topic, we may appropriately consider it here. As the "curb" market is in itself an exchange of a kind, we do not now refer to that in speaking of the market off the exchange. Through the weave of telephone wires the whole financial section of a city, which is a financial center, is one great exchange. Either the sales manager of the banking house, or some special "trader" or telephone man, constantly watches opportunities to do business of a trading nature. Through its salesmen the house offers to its clients especially

the securities it owns, those "on its list," as the phrase goes. None of these securities may exactly meet the requirements or ideas of the client. He may have definitely in mind some particular issue. The salesman, finding that the securities on his list do not satisfy the client, may suggest some other security obtainable in the market. When the client expresses a preference for such a security, the salesman will communicate with his office and name the price limit the client will pay. It then becomes the task of the trading man of the house to make the purchase; even if it is a listed bond he will probably inquire around the street to see if he can pick it up more advantageously than by putting in an order on the exchange. He may telephone to the trading men in several banking houses in the effort to locate the bonds he wants. For special reasons he may not care to disclose the fact that he is in the market for the security. In that case he will make use of the services of one of the many street brokers who come into his office every day.

Mention of the street broker calls for a further word about him. He is not, as some one might naturally surmise, a member of the curb exchange, but a man who daily makes the rounds of the dealers in securities

to see if he can match up orders and by so doing make a little commission for himself. Such a broker may have received an order to sell some C. B. & Q. Collateral Joint 4's. In the course of his rounds he steps into the office of Jones & Company. On learning that they are not interested in his Joint 4's, or in any other security that he may have an idea he would be able to supply or to sell, he will ask Jones & Company's trading man if he wants to buy or to sell anything. Jones & Company's order may call for some X. Y. Z. Debenture 4's and the trading man may indicate this to the broker, and some idea of the price he would pay, as, say, $98\frac{3}{4}$. The broker now has something further to work on. In the course of the next hour of his rounds he may find that Robinson & Company display some interest in selling X. Y. Z. Debenture 4's, but want $98\frac{7}{8}$. The bid and asked price are an eighth apart, without allowing any commission. The broker may succeed in bringing Jones & Company up and Robinson & Company down an eighth each. That would allow the broker an eighth. It may be that the purchaser will not come up the full eighth, but will make the price he will pay three quarters plus a sixteenth. The offer will be expressed that way instead of $98\frac{13}{16}$. The broker will regret-

fully put the transaction through on that basis. It means that he makes a commission of only one sixteenth, but after all he has done a piece of business. He may give up his principals and let them clear the transaction. Very likely, however, one of the houses is taking advantage of his services for the very reason that it does not wish to appear as principal in the transaction. In that case the broker will have to clear the transaction himself. Very likely the broker has desk-room in or near the offices of some banking house, which, in return for such services as the broker can render, will clear the broker's transactions. This is a matter of some importance, because it involves having a bank account large enough to get a check certified with which to pay for the security. Of course, on delivery of the security the same day the broker will in return get a check in payment to refund the account, so there will be no loss of interest. But for a little while the account will be debited the cost of the bonds. Since the transaction may run up to \$50,000 or more, the reader will see that the minutes or hours between the time the broker has to pay for the security and the time he gets paid for it are important ones for him to bridge.

• If a broker can make arrangements for

these clearings, he need not have any capital. He is acting entirely as broker. Desk-room, a place to telephone from, and where he can be reached by any one who may want his services, are the material needs of his business. Otherwise his office is wherever he happens to stand.

Since the street broker was the only broker concerned in the transaction, he could put the purchase and sale through cheaper than it could be done on the exchange. There one broker would be acting for the seller and one for the buyer, and each must, by the rules of the exchange, charge a full eighth. So the transaction would cost a quarter of a point on the exchange. The street broker, though expecting an eighth, in this instance has put it through for a sixteenth. Of course, if both the banking houses had been members of the exchange, but without a partner actually on the floor, which would be the usual situation, some floor broker would put the transaction through, as permitted by the rules, for another member on the basis of \$2 for an amount of \$10,000. Under such circumstances the employment of the street broker would not have had the advantage in the matter of commissions. Even then the street broker would have the advantage of working quietly. A bid for a large block,

\$25,000, \$50,000, or more, on the exchange would have more of a tendency to stiffen prices than the efforts of a street broker to find some one ready to sell, but not offering to sell for the same reason, namely, the tendency of an open offer of a good-sized block to depress the market.

Visits of these street brokers and telephone calls from banking house to banking house indicate the course of the market, and when they result in transactions they make the market. The trading man in the banking house becomes intimately acquainted with the ways of the market and sensitive to its indications. From the tone of brokers and other trading men he knows that the market in X. Y. 5's, which were worth $98\frac{7}{8}$ at 10 A.M., has softened, and that if he wished to purchase at 11.30 A.M. he could probably get them at three quarters or better.

One phenomenon, somewhat amusing, shows the sensitiveness and range of this outside general market in securities. Often when the trading man starts an inquiry he finds his own inquiry coming back to him from many quarters. Assume that he starts out an inquiry through a street broker for a good-sized block of X. Y. 5's. The next house at which the broker inquires may not have any, but may surmise that it might get

some from another house and its trading man will, phone an inquiry. That house does not have any of the bonds, but, eager to do business, its trading man may recollect that at some time in the past he had been offered a block from Montreal and telegraphs to some Montreal dealer. The Montreal man may have an idea that he could get them in London and cables. The London correspondent may in turn cable to New York, and the trading man of the New York house receiving the cable, and knowing nothing whatever of the real origin of the inquiry, may telephone to the very house that first sent the inquiry on the way. Usually the inquiry will come back by a much shorter route to the man who started it. Within an hour after starting the search the trader may recognize his own inquiry in half a dozen telephone calls. This is significant in showing the scope of the market off the exchange, and how far-reaching and thorough is the search of the outside market to find a buyer or a seller for a given security at the most advantageous price.

CHAPTER III

SYNDICATES: JOINT ACCOUNTS AND UNDERWRITINGS

WHEN a corporation requires at one time an amount of financing too great for the banking house which has undertaken to supply the corporation's need for capital, or to which the corporation is applying, to supply alone, the banking house seeks coöperation. How great the amount must be for the banking house to seek aid depends, of course, on the particular house and its "placing power"; that is, its ability to distribute securities and lodge them in the hands of investing financial institutions or individuals. With a particular house the amount may also vary from time to time. It will depend on the other commitments of the house at the time, its opinion of the probable course of the market, and, in general, all the considerations which enter into a determination of the amount of risk it is willing to assume at a given moment.

Such coöperation in the sale of securities takes the form of joint accounts and underwritings. Though these two business methods — joint account and underwriting trans-

actions — differ in degree rather than in kind, they differ enough to make the two terms desirable. Joint accounts are more common than underwritings. Though an underwriting may not follow a joint account, ordinarily a joint account precedes an underwriting. Sometimes an underwriting transaction is entered into without any joint-account transaction preceding it. A description of the two transactions will make the situation clearer than any amount of preliminary general statement.

Let us assume that a banking house has committed itself to purchase, or learned that it can purchase, an issue of corporation bonds. The transaction is larger than at the moment it cares to undertake to handle entirely on its own account and it seeks the assistance of several other banking houses. Ordinarily the house is in the position of extending an invitation rather than of asking a favor. It has the business in hand. Though it has done part of the work already, it will not stand in any better position with regard to the profits than the other houses which coöperate.

Each house invited to coöperate either states that it is not in a position to do so, or that for some other reason it does not care to, or else indicates how large a participation it wishes to take. The word “participation” is the technical term for the share

in the transaction that each house takes. Profits are divided and losses shared in proportion to the size of the participation.

We will assume an issue of \$5,000,000, and that the house of Brown & Company regularly does the financing for the issuing corporation, or for some other reason is in a position to purchase this particular issue from the corporation. Of the several houses Brown & Company invite to participate in the purchase and sale of the securities, Jones & Company, Smith & Company and Robinson & Company decide to join in the undertaking. It is decided that Brown & Company shall keep a participation of \$2,000,000; Jones & Company to take a participation of \$1,500,000; Smith & Company, a participation of \$1,000,000; Robinson & Company, a participation of \$500,000. The number and amounts of the participations may vary to almost any extent. Our supposititious case, however, may be taken as fairly representative.

Assume that Brown & Company have agreed to pay the corporation 95.50 for the bonds. We will assume also that the situation demands that the corporation receive all the money in one payment. This, of course, would be the case in a refunding operation. If the corporation had been financing on

short-term securities in anticipation of a better market and had, say, \$4,500,000 of such "notes" about to mature, it would require the cash in order to meet the maturity. Let us suppose also that the corporation needs some cash for the extension or improvement of its plant or line. The sale of \$5,000,000 bonds at 95.50 will meet the payment of the \$4,500,000 of notes that are falling due and will provide in addition the estimated requirement of \$225,000 of cash.

To facilitate expression and speak in the ordinary language of the street, we may use the term "syndicate" to express either the joint account or the underwriting as a form of coöperation in the sale of securities. The syndicate must be prepared on the stipulated day to pay the corporation \$4,775,000 and take delivery of the securities. After the negotiations for the purchase of the securities and the determination of the price, the requirement of making payment presents the first matter that must be settled in the formation of the joint account. Presumably, the banking houses forming the syndicate are not prepared to pay for the bonds out of their own capital, but must arrange for a loan in order to "take them up." Financing the purchase and holding of the bonds during their sale is one of the most important

parts of the whole transaction. It is called "carrying" the bonds.

Since many details necessarily come up in the course of the transaction, and because it is important that some one have authority to act in these matters of detail, one member of the syndicate must occupy the position of "manager." Because Brown & Company were able to purchase the bonds and brought the other members of the syndicate into the transaction, they would naturally become syndicate manager in the particular transaction we are describing. As syndicate manager they might arrange a loan to carry the entire issue of bonds for the syndicate. The bank advancing the funds would take the bonds as collateral security for the loan. It would not, however, advance as a loan the entire amount the syndicate must pay for the bonds. Let us assume that this particular security is of such a character, is assured of a sufficiently good market, and has such qualities as an investment that a bank would feel justified in lending 85 per cent of the purchase price. Then the bank will loan \$4,058,750 on the security of the entire issue as collateral. The syndicate must pay \$4,750,000, or \$716,250 more than the bank will loan, in order to take delivery of the bonds from the corporation when the time

comes. This \$716,250 the syndicate must supply from its own capital in order to swing the transaction.

Let us assume that the syndicate manager has undertaken to procure a loan or loans on the entire amount of bonds and that Brown is the particular individual of Brown & Company who is handling the matter. He will call on each of the other members of the syndicate to supply funds in proportion to their participation sufficient to make up the required \$716,250.

Recapitulating, the several participations stand as follows: —

Brown & Company.....	\$2,000,000
Jones & Company.....	1,500,000
Smith & Company.....	1,000,000
Robinson & Company.....	500,000
	<hr/>
	\$5,000,000

For these \$5,000,000 bonds the syndicate must pay the corporation \$4,775,000. Brown & Company, the syndicate managers, are arranging a loan at the bank for 85 per cent of the purchase price, or a total of \$4,058,750. This leaves \$716,250 to be contributed by the syndicate members in proportion to their participations as follows: —

Brown & Company.....	\$286,500
Jones & Company.....	214,875
Smith & Company.....	143,250
Robinson & Company.....	71,625
	<hr/>
	\$716,250

When the day comes for taking delivery of the bonds and paying the corporation for them, each of the members of the syndicate pays into the bank which is making the loan its proportional contribution as just stated. According to instructions the corporation will deliver the bonds at the bank, accompanied with a draft for the \$4,775,000 purchase price, and the bank will make the payment with the loan of \$4,058,750 which it is making to the syndicate, and the \$716,250 the syndicate manager has deposited as the contribution of Brown & Company and the other members to make up the balance. This detailed description of the banking transaction is not meant to indicate that the business always follows exactly that form, but simply to state a form that it might follow and make clear the immediate sources of the money paid over to the corporation. By this method it is seen that the bonds are "carried" through a loan or loans arranged by the syndicate manager on behalf of the entire syndicate. Such a method of financing the payment for the bonds is called "undivided carrying."

Following another method it might have been the agreement that each member of the syndicate should finance the payment, and take up the bonds, to the amount of its

participation in the account. This method is called "divided carrying." If the account were arranged in this way, then each member would arrange its own loan at its own bank or banks, and the corporation, under instructions, would deliver to it there bonds to the amount of its participation.

If worked out by the "divided carrying" method, the situation would stand this way:—

<i>Syndicate member</i>	<i>Participation</i>	<i>Value at 95.50</i>
Brown & Company	\$2,000,000	\$1,910,000
Jones & Company	1,500,000	1,432,500
Smith & Company	1,000,000	955,000
Robinson & Company	500,000	477,500
	<hr/> \$5,000,000	<hr/> \$4,775,000

*85% of purchase price of
95.50 procured by each
member on loan*

\$1,623,500

1,217,625

811,750

405,875

\$4,058,750

*15% of purchase price advanced
by each member from capital
to "take up" the bonds*

\$286,500

214,875

143,250

71,625

\$716,250

We will assume now that the method of carrying the bonds has been settled as either "undivided carrying," the syndicate manager arranging the loan to carry the entire issue, or as "divided carrying," by which each member arranges its own loan and carries its own participation. The origin of these terms is obvious enough. We will as-

sume also, as would probably be the case with an issue of this size, that the joint-account syndicate will not seek further coöperation, by arranging an "underwriting" syndicate, but will proceed to sell the bonds directly to investing financial institutions and to individual investors. The next thing to settle is the selling price. Of course this was determined essentially before the purchase price was decided on. When Brown & Company agreed to take the bonds at the price of 95.50, they had already come to a conclusion as to the price at which the bonds could probably be sold. From the price at which they believed the bonds could be sold they deducted an amount which they considered would pay the expenses of the business, if the bonds sold as readily as it was thought they would, and leave what, all things considered, they would regard as a fair profit. In this way Brown & Company determined the price they were willing to pay for the bonds. If they had done something toward arranging the syndicate, or actually had arranged the syndicate before finally agreeing to purchase the bonds, the purchase price was determined in this way on consultation with the other syndicate members.

It should be stated before proceeding that special arrangements for carrying the bonds

might be made other than those described. One member might agree for some special advantage, or because of some special ability, to carry all the bonds and advance all the capital necessary. Or, if one member did not arrange to carry all the bonds, the several members might carry them in amounts other than the amounts of their participations. It is safe to say, however, that only a very small minority of joint-accounts arrange for carrying the bonds in any other way than those described.

This seems a proper place to mention the profit or loss in interest. If the syndicate bought the bonds on a 5 per cent basis and is able to borrow at the banks at 4 per cent, obviously the carrying itself does not make an item of expense to the syndicate, but yields a profit to the account. If the bonds are bought on, say, a 4.5 per cent basis, however, and the syndicate must pay the banks 5.5 per cent interest on the loan, again obviously the carrying makes an item of expense to the account. The street picturesquely says of the situation, in which the rate of interest paid is greater than the rate of interest received, that "the bonds are eating their heads off."

We must return now to the question of the selling price. Let us assume that the syndi-

cate agreed to the purchase price of 95.50 because it believed the bonds could be sold at a price of 98.50, and that the bonds would be easy enough to sell to make the difference of three points cover the expense and give a fair profit.

Mention of the selling price raises the whole issue of division of profits and the bearing of losses. Unless otherwise stipulated the account will be entirely regular; that is, profits will be received and losses borne in proportion to the respective participations. This is the ordinary unlimited liability account. More commonly the banking houses call it "undivided liability." The word "unlimited" describes the situation more accurately. In an unlimited liability account profits are received and losses borne in proportion to the participations, entirely irrespective of the amount of the securities the member of the syndicate may sell.

It is the regular understanding in these transactions that each member of the syndicate will engage in selling the securities. When a banking house joins a syndicate the other members assume that it expects to sell an amount of bonds approximately equal to its participation. Unless a "selling commission," which we will discuss a little later, is arranged for, it makes no difference in the

distribution of profits or the bearing of losses whether the house sells bonds to several times the amount of its participation or does not sell any bonds at all. If a house which has been "taken aboard" does not sell any bonds, or does not sell bonds to an amount somewhat approaching its participation, then the house is said to have been "given a ride." A house which fails to do its share of the selling will suffer the penalty of being regarded as an undesirable associate in joint-account transactions and, on a frequent repetition of failure, will not again be invited to join.

Assume that this particular joint account is successful and results within a reasonable time in a sale of all the bonds at the agreed price of 98.50. Members of a syndicate naturally do not sell the exact amount of their participations in any case. In the particular case we are discussing we will assume the several members sold these amounts: —

Brown & Company	\$2,250,000
Jones & Company	1,000,000
Smith & Company	1,150,000
Robinson & Company	600,000

On this transaction in selling \$5,000,000 of bonds the total of the difference of three points, between the price at which the bonds were bought and that at which they were sold, amounts to \$150,000.

Of course this is not net profit any more than any difference between a purchase and a selling price. Actual expenses of the syndicate itself amount to considerable sums. Such expenses must necessarily vary widely in different joint-account transactions. Any figures given here are not to be taken as typical or even as approximating the figures of any account that ever existed. Like all other figures on the matter, they are presented simply to illustrate the principle and methods of syndicate transactions. Expenses connected with delivery of the securities from the issuing corporation to the syndicate and from the syndicate to the purchasers, legal expenses, telegrams and telephone calls, circulars and advertising are a few of the many expenses of conducting the account. The several members of the account themselves bear all the direct cost of the selling, salaries and traveling expenses of salesmen, and their own office overhead charges.

We will assume that during the process of sale the interest accruing on the bonds amounted to \$2500 more than interest paid out on the loans to carry them. We use the word "accruing" advisedly. No interest may actually have been paid on the bonds between the dates within which they were sold. Since they are sold at *98.50 and interest*,

on each sale the amount of interest accrued to the date of sale is added to the sale price. We will also assume that all the expenses of the syndicate amount to \$27,500. So, adding the profit from the interest account and deducting the expenses, the syndicate has left \$125,000 as syndicate profits.

Although Jones & Company did not sell bonds equal in amount to their participation and the others all sold bonds in amounts more than their participations, the syndicate manager will distribute this \$125,000 to the several members strictly according to their participation. The participation of —

Brown & Company	was	4 tenths
Jones & Company		3
Smith & Company		2
Robinson & Company		1
		<hr/>
		10

Since one tenth of the profits is \$12,500, it follows that the syndicate manager will distribute to —

Brown & Company	\$50,000
Jones & Company	37,500
Smith & Company	25,000
Robinson & Company	12,500
	<hr/>
	\$125,000

Again, we must remind ourselves that though these sums are profits of the syndicate, the several members cannot count them

as net profits. Each member has had to bear selling expenses, including perhaps some advertising, certainly office overhead and the pay and expenses of salesmen.

If, instead of proving a profitable transaction, the syndicate should find that it could not sell the bonds at 98.50, but that, on the contrary, financial conditions had become such that it could not sell the bonds for as much as it paid for them, what would happen? We will assume that the syndicate meets such a condition of affairs. If the syndicate is not satisfied simply to hold the bonds in expectation of a better market, when it can sell them without a loss, it can choose between lowering the selling price to one at which it can "move" the bonds now or distributing the unsold bonds to the members and dissolving the syndicate. Ordinarily the members will not want to continue the syndicate to hold the bonds for a better market. The better market is always problematical and may well seem too remote. Some members may want to liquidate the account and take their loss. The syndicate is not so likely to lower the selling price as it is to distribute the bonds. Some members may hold the opinion that the market will improve and feel reluctant to take a loss. Various considerations will determine the

decision. Suppose the syndicate determines to distribute the bonds and dissolve. We will assume that it has sold \$2,000,000 of the total issue of \$5,000,000. Again, for the purpose of this distribution it does not make any difference how many bonds each member has sold; the unsold bonds will be distributed to the members in proportion to their participations. To show more specifically the working of the transaction, we will state an assumption of the amount of bonds each member has sold, and say that

Brown & Company have sold	\$200,000
Jones & Company have sold	300,000
Smith & Company have sold	900,000
Robinson & Company have sold	600,000
	<hr/>
	\$2,000,000

Robinson & Company have sold more than the amount of their participation; Smith & Company, almost the amount; Jones & Company, only one fifth; and Brown & Company, only one tenth of their participations. Of the total issue \$3,000,000 of bonds remain unsold. Just as in the case of the profits these will go to the members in proportion to their participations. Brown & Company will get four tenths; Jones & Company, three tenths; Smith & Company, two tenths. Although Robinson & Company have already sold much in excess of their participation,

they will nevertheless have to "take up" one tenth of the unsold bonds. So the unsold bonds will be distributed as follows:—

Brown & Company must take up	\$1,200,000
Jones & Company must take up	900,000
Smith & Company must take up	600,000
Robinson & Company must take up . .	300,000
	<hr/>
	\$3,000,000

With an original participation of only \$500,000, Robinson & Company have become responsible for a total of \$900,000 of bonds. On the \$2,000,000 of bonds sold the syndicate made three points between the purchase price and the selling price, a total of \$60,000. Let us assume a loss on the interest account in carrying and expenses to a total of \$30,000. The manager would distribute the \$30,000 net syndicate profit in this way: Brown & Company, \$12,000; Jones & Company, \$9000; Smith & Company, \$6000; Robinson & Company, \$3000. The joint account is now closed. The several members are carrying on their own account the bonds distributed to them and may dispose of them in such ways and at such prices as they see fit.

Instead of having the syndicate distribute the unsold bonds, let us assume that, after holding them for a considerable time, it decided to reduce the price to one at which the bonds will "move" in the existing market.

The members of the syndicate decide that the bonds will sell at 94. On offering them at that price the syndicate succeeds in their disposal. A marked advance in interest rates undoubtedly accompanied so sharp a decline in the market. We have assumed, too, that the syndicate carried the bonds a considerable period before it determined on the reduction in price. So we can fairly assume a loss in the interest account, which we will place at an average of one per cent for four months on an average loan of \$3,000,000. This would make a loss in interest of \$10,000. The syndicate has sold \$3,000,000 of bonds at one point and a half below the purchase price, a loss of \$45,000. We will assume that the holding of the bonds for the joint account has increased the total of syndicate expenses to \$45,000. So the account has total costs and losses of \$100,000 against which it can offset only the \$60,000 advantage of selling price over purchase price made on the first \$2,000,000 of bonds. Syndicate members would have to bear the loss of \$40,000 in this way: —

Brown & Company would stand a loss of	\$16,000
Jones & Company would stand a loss of	12,000
Smith & Company would stand a loss of	8,000
Robinson & Company would stand a loss of ..	4,000
	<hr/>
	\$40,000

We should keep in mind that the syndicate apportions the losses in this way in the face of the fact that Robinson & Company sold more than their total participation at the full advantage of three points above the purchase price. It does not make any difference in the result, either, how many each member sells of the \$3,000,000 of bonds which the syndicate sells at the price of 94. Even if the members sell these bonds in amounts as disproportionate to their participations as the \$2,000,000 they sold at 98.50, the losses would be distributed as indicated. If it is objected that this is obviously an unfair situation, we may answer that the parties knew the kind of a transaction in which they engaged and its liabilities. A group of people, who probably know each other exceptionally well, are willing to accept the hazards of fortune and take the chances of loss for the sake of the chances of gain in the coöperation. To keep this fact absolutely clear we can hardly too often reiterate that each member of the syndicate must add to his share of the account loss the large direct cost of selling.

Sometimes a group of investment bankers wish to coöperate without running the risk of this unlimited liability of the regular joint account, "undivided," as the word is, as to

liability. They may in that case agree to an account limited or "divided" as to liability. Such an account would naturally also be divided as to carrying. Each member of the syndicate would take up and carry an amount of the bonds equal to its participation and would proceed to sell the bonds as if on its own account, except that it cannot vary from the syndicate price so long as the account continues. Each member would be responsible for the expenses of the syndicate in proportion to its participation. Otherwise each member, subject to the syndicate price, deals with its share of the bonds as if they were its own, is responsible for selling, and enjoys the profits and suffers the losses of its own participation. At the close of the syndicate each member must take for its own account that part of its participation which it has not succeeded in selling. If the houses of Brown, Jones, Smith, and Robinson, in the transaction just sketched through, had formed an account divided both as to carrying and as to liability (limited liability), and, instead of the amounts before indicated, Brown & Company had sold \$300,000 and Robinson & Company had sold \$500,000, the transaction would have worked out as follows: —

<i>Member</i>	<i>Participation</i>	<i>Sold during life of account</i>	<i>Must still sell</i>
Brown & Company.....	\$2,000,000	\$300,000	\$1,700,000
Jones & Company.....	1,500,000	300,000	1,200,000
Smith & Company.....	1,000,000	900,000	100,000
Robinson & Company.....	500,000	500,000	000,000
	\$5,000,000	\$2,000,000	\$3,000,000

Obviously this makes a very different showing from the regular unlimited liability transaction.

Occasionally some variations are made in the general form of the joint-account transaction as described here. People entering into a syndicate sometimes make stipulations which modify the full unlimited liability without narrowing the account to the strictly limited liability form. Such syndicates present possibilities of modification far beyond anything yet attempted in practice. If such modifications are desirable we may well leave them to recommend themselves.

Before going on to a brief description of the management of an account, we should mention one way in which joint-account syndicates commonly modify the effects of inequalities in selling. As we have seen, some members may sell bonds to an amount out of proportion to their participation.

Selling commissions afford some mitigation of these inequalities. If the account agreement provides for a commission, as it ordinarily does, then the members actually selling bonds get the stipulated commission on the sales to augment their profits or lessen their losses. Suppose a half a point selling commission had been allowed in the transaction in which Brown & Company sold \$200,000, Jones & Company, \$300,000, Smith & Company, \$900,000, and Robinson & Company, \$600,000 at the price of 98.50 and all the rest of the bonds had been distributed. Then the \$30,000 of net syndicate profits on the sale of the \$2,000,000 at 98.50 would have been cut down by the half a point on the \$2,000,000, or by \$10,000. The result would change in this way: —

<i>Member</i>	<i>What each receives as proportionate distribution of profits of \$20,000 when half per cent selling commission allowed</i>	<i>Selling commission on bonds actually sold</i>	<i>Profits plus commission (\$30,000)</i>	<i>What was received when no commission allowed and distributed</i>
Brown & Company.....	\$8,000	\$1,000	\$9,000	\$12,000
Jones & Company.....	6,000	1,500	7,500	9,000
Smith & Company.....	4,000	4,500	8,500	6,000
Robinson & Company..	2,000	3,000	5,000	3,000
	\$20,000	\$10,000	\$30,000	\$30,000

Such a statement sufficiently shows that the allowance of a selling commission may con-

siderably change the results in favor of the member which performs a disproportionate share of the work.

Many brokers and other dealers in securities may desire to sell some of the bonds of this issue. Regular clients of such brokers and dealers may wish to buy some of the bonds of the issue, but naturally prefer to purchase through their customary channel. To get the benefit of such possible extension of the market the syndicate may allow a broker's commission. If the syndicate allows its members a selling commission, as just described, presumably the member which makes a sale through a broker entitled to a commission will have to pay the broker's commission. Since the selling member's commission we have assumed is one-half a point, — that is, one-half per cent on the par of the securities, — the broker's commission would be one eighth or a quarter, — that is, that fraction of one per cent on the par of the securities. Both the size of the member's commission and of the broker's commission would ordinarily have some relation to the difference between the price the syndicate paid for the securities and the price at which it is selling them. The syndicate established that difference between the purchase and the selling price on its estimate of probable diffi-

culty in selling the securities. Of course, by this we mean the difference originally established. If a change in the market forces a lowering of the price, or permits an advance, that is quite another matter. A member must not share its selling commission, except with a broker in accordance with the syndicate agreement, and a broker must not share his commission with any one. Fairness to all, both that the members may have an equal chance to sell and that purchasers may all receive the same treatment, demands a single price to all. A member or a broker discovered in "splitting commissions" would suffer an injury in reputation that would tend to make it difficult to participate in further business of this kind.

So far we have not considered the internal management of the account, but have stated simply its general form, liabilities, and incidents. In the details of its management a joint account presents a somewhat intricate situation. Here are several independent selling organizations selling the same issue. All the bonds are deposited as collateral for a loan or several loans. To make delivery of any of the bonds to a purchaser on a sale, they must be released as collateral. The possibility of overselling the issue, that is "selling short" of the bonds, must be guarded

against. Such matters all require careful attention.

The syndicate manager takes charge of all these details of the account, keeps the syndicate books, and generally performs the service of a clearing house for joint-account affairs. The largest amount of detail work comes in arranging for the delivery of the bonds. Members must promptly report to the manager all sales of the securities. Quickness in reporting sales is essential in the business of selling securities.

Consider the situation first in the case of undivided carrying, in which the manager has arranged the loan or loans to carry the entire issue. This offers the simplest state of affairs. Brown & Company are the managers. A salesman of Robinson & Company telegraphs to the office of his house that he has sold ten of the bonds. On receiving the telegram Robinson & Company immediately telephone to Brown & Company the fact that they have sold ten bonds. In the course of the day Robinson & Company have occasion, in a similar way, to telephone to the syndicate manager the successive further sales of three, two, and five bonds. Robinson & Company want these bonds the next day to deliver. But the bank which has loaned the syndicate the funds to carry the

bonds has possession of all of them as security for its loan. It will not give up any of the bonds unless the syndicate reduces proportionately the amount of money it has borrowed. We have assumed that the bank loaned 85 per cent of the purchase price. Since the bonds cost the syndicate \$955 per bond, the loan was at the rate of \$811.75 for each bond. The manager must pay off this amount for each of the bonds it asks the bank to release. Since Robinson & Company want twenty bonds to deliver the next day they must supply the manager with sufficient funds to pay for each bond. The amount Robinson and Company actually turn over may be anything between this and the full \$985 which they will receive from their clients when they deliver the bonds. Robinson & Company had already paid out of their own capital 15 per cent of the purchase price, to make up the difference between the \$811.75 that the bank loaned and the \$955 that the syndicate paid, or \$143.25 for each bond on the amount of their participation. By one arrangement, perhaps one of the simplest, Robinson and Company, for each bond they want to deliver, pay over to the syndicate manager \$841.75, which is the sum of \$985 Robinson & Company will receive from their client less the \$143.25 they

have already paid. Obviously this would leave all the gross profits — that is, the difference between the purchase and selling prices — in the hands of the syndicate manager for him to distribute at the close of the transaction. It would also return to the member capital it has tied up in the transaction from time to time as the member sells bonds. If the transaction should prove to be a very quick one, the bonds all sold, and the syndicate dissolved in the course of a week or ten days, this releasing of capital would not be important; but if the syndicate should continue for a number of months it would be a matter of consequence. On the other hand, if Robinson & Company should sell more than the amount of their participation, they would, for each bond of this excess amount, have left in their hands \$143.25 of syndicate capital which they would have to account for to the syndicate manager.

If the syndicate agreement were that each member must pay to the syndicate manager the full selling price in order to get delivery of bonds, then the manager would have accumulating, for the member's account, this \$143.25 for each bond sold. Of course the manager may distribute this fund of unnecessary syndicate capital back to the members, from time to time as it accumulated. As

will be indicated later, several other plans are possible. Though the term is not commonly used, the amount the members pay the manager in order to get bonds for delivery is sometimes called the "take-down price." Often it is stated simply that the member "pays" the manager for the bonds.

We have assumed the situation of an account undivided as to carrying, in which all the bonds are carried by a loan arranged by the manager. If the syndicate has divided the bonds for carrying purposes and each member has arranged the loan for the amount of its own participation, deliveries to purchasers would be made only through notification to and instruction from the manager. In this way the manager keeps entire control of the account and can adjust the amount of bonds each member is carrying in proportion to that member's participation. Members must report all sales to the manager promptly, as in the case of the undivided carrying account. The manager will either direct the member to make delivery from bonds the member is carrying or will procure bonds from some other member for the member who has made the sale. If the member makes delivery from the bonds it is carrying, it will be accountable to the syndicate manager for the difference between the

purchase price, which the member has already paid, and the price at which the bonds are sold. If the manager wishes to supply the member which has made the sale with bonds for delivery from those which some other member is carrying, then the manager will call on the selling member to pay just the same as in the case of the undivided carrying account, and, of the money so paid in by the selling member, the manager will pay over to the carrying member, from which the manager wants to take the bonds, a sum equal to the purchase price of the bonds, which is the amount the carrying member had borrowed and advanced to carry them. The carrying member then has the funds to pay off the *pro rata* of its loan and is reimbursed for the *pro rata* of the capital advanced for the syndicate operation.

To recapitulate, let us take the case of the first account presented. We assumed that the syndicate sold all the bonds at the full price of 98.50 and that the syndicate expense totaled \$27,500, of which profit on the interest account reimbursed \$2500. Assume that this account was undivided as to carrying and that the members were to pay the manager the full selling price when calling for bonds to deliver. Then, taking a single bond as the unit transaction, we get these results:

Selling price which members paid to manager when they took bonds for delivery.....	\$985.00
Manager used to pay off <i>pro</i> <i>rata</i> of loan at bank in order to release bonds from col- lateral.....	811.75
Manager pays back to mem- bers their contribution to the syndicate capital.....	143.25
Manager uses to pay syndicate expenses, which totaled \$27,- 500, less \$2500 made on in- terest account, or \$25,000, i.e., for each of the 5000 bonds of the issue.....	5.00
Seller's commission	5.00
Syndicate profits distributed to members in proportion to their participations.....	<u>20.00</u>
	\$985.00

All the conditions governing the conduct of the account are not necessarily determined at the time the syndicate is formed. Ordinarily only absolutely necessary matters are stipulated at the time the members agree to join. After the formation of the syndicate the members hold a meeting to settle such further things as need to be determined. Even so important a consideration as the exact selling price may be left to this meeting. The several banking houses joining in the account will not sign a formal legal document drawn up by their lawyers. They will simply confirm by an exchange of letters the

understanding arrived at in the formation of the account and in the subsequent meeting.

Our discussion of the account has shown in a general way the powers and duties of the manager. We assumed, what would ordinarily be the case, that the member who had control of the issue, or who was most influential in forming the syndicate, became manager. Such an account as we have discussed has really the characteristics of a partnership and the manager would in no sense be a dictator. Each member would have an opportunity to exert an influence in determining the conduct of account affairs. Naturally the manager would keep the books of the account and attend to the distribution of profits or apportionment of losses.

Showing the informal manner of the organization of such a syndicate as we have described these letters might be the only evidence in writing of its terms:—

July 8th, 1916.

MESSRS. JONES & COMPANY,

DEAR SIRs:—

We are writing to confirm our conversation of this morning to the effect that you will join Smith & Company, Robinson & Company, and ourselves in a joint account for the purchase and sale of \$5,000,000, Central & Western R.R. Co. 5%, 20 year bonds due August 1st, 1936, for

which a price of 95.50 and interest will be paid to the corporation, New York delivery and payment.

You are taking a participation of \$1,500,000 in the account.

We are to be manager of the account.

The account will be divided carrying, unlimited liability. The rules for the conduct of the account will be agreed on at a meeting of the syndicate members to be held as soon as possible.

Will you please let us know if your understanding of our agreement is in accord with this letter?

Very truly yours,

BROWN & COMPANY.

July 9th, 1916.

MESSRS. BROWN & COMPANY,

DEAR SIR: —

Your letter of the 8th inst., referring to the joint account for the purchase of Central & Western R.R. Co. bonds, correctly states our understanding.

Very truly yours,

JONES & COMPANY.

July 10th, 1916.

MESSRS. JONES & COMPANY,

DEAR SIR: —

We are writing to confirm the understanding for rules of the account entered into at a meeting held at our office this morning of the members of our joint account in Central & Western R.R. Co. bonds.

We determined that the selling price should be 98.50 and interest. A member shall have a

selling commission of a half and may allow a broker's commission of a quarter. Expenses of a member for purposes of the account shall be deducted from the amount allowed him as commissions. Delivery shall be only on the manager's order and on receipt by him of the selling price and interest without allowance for commissions. Members may offer and sell the bonds without restriction as to territory. All advertising shall be done and circulars prepared and printed by the manager at the expense of the account in the name of Brown & Company, Jones & Company, Smith & Company, and Robinson & Company, in the order stated. Unless earlier terminated by agreement the account shall continue until all the bonds are sold.

Will you please confirm this understanding of the rules of the account?

Very truly yours,

BROWN & COMPANY.

July 11th, 1916.

MESSRS. BROWN & COMPANY,

DEAR SIRs: —

Your letter of the 10th inst., referring to the rules of the joint account for the purchase of Central & Western R.R. Co. bonds, correctly states our understanding.

Very truly yours,

JONES & COMPANY.

Since these syndicate transactions are regularly entered into and carried out in good faith, and the parties are thoroughly

familiar with them, serious difficulties seldom arise. The agreements, however, might well be more fully expressed.

Notice that these letters say that the members may offer and sell the bonds without restriction as to territory. If banking houses located in different cities compose the syndicate, the agreement sometimes restricts the selling of each member to that member's special territory. Assuming that Brown & Company have their principal office in New York City, Jones & Company in Boston, Smith & Company in Philadelphia, and Robinson & Company in Chicago, then Jones & Company might have all of New England reserved for them, Brown & Company have the City and State of New York and northern New Jersey; Smith & Company, the State of Pennsylvania and southern New Jersey; Robinson & Company, Ohio, Illinois, Michigan, and Wisconsin. Any member would be free to sell in the unrestricted territory. Under such an arrangement the syndicate might agree that each member should do its own advertising and in its own name only. Generally syndicates do not restrict their members territorially. The larger houses have offices in several cities and find their clientèle over a rather large area. If their territory were restricted they would not be able to

exert their full selling power. Besides, it is rather problematical how many more bonds a house would sell by reason of having reserved territory.

Unless otherwise expressly stipulated the syndicate comes to an end when its purpose is accomplished by the sale of all the securities. By mutual agreement the account may be closed at any time, and the agreement forming the account ought to stipulate that the vote of a majority, or a majority in interest, should govern for this as well as for other questions that may arise.

Recapitulating the considerations entering into the formation and carrying out of a joint-account transaction, we may consider it then as represented by the agreement forming the account and the supplementary agreement providing for what we may call the rules of the account, and summarize them by an outline of the matters that need be taken care of.

Agreement forming the Account should provide for these Matters:—

1. *Name.*

The name or names in which the purchase is made and the order in which they are to appear.

2. *Purchase price.*

3. *Carrying.*

Divided, undivided, or special.

4. *Liability.*

Unlimited, limited, or limited but unlimited as to selling; and option to limit and proportional lessening.

All other matters of the account are to be provided for in rules of the account expressed in a supplementary agreement.

Rules of the Account should provide for:—

1. *Selling price.*

2. *Broker's commission.*

3. *Member's selling commission.*

Shall there be any at all?

If a commission, shall it begin at once?

Or only after the member has sold his proportion?

4. *Duration of account.*

To continue until securities are sold, unless sooner terminated by agreement of members.

To continue for a definite period and to be terminated at the end of that period, unless members agree to extend.

5. *Take-down price.*

Selling price.

Or selling price less member's commission.

Purchase price less any *pro rata* already paid by members.

Selling price less any *pro rata* already paid by members.

Selling price less commission and any *pro rata* already paid by members.

6. *Delivery.*

Only on manager's order.

Without manager's order.

7. *Territory.*

Unrestricted.

Restricted.

8. *Advertising.*

By manager in name of all at expense of account.

Or by each in the name of all and at his individual expense.

Or by each in his own name and at his own expense.

Since a joint account is one of the commonest transactions with our bond houses, it speaks well for the general good faith and mutual understanding with which these undertakings are carried out that the cases which express the law applicable to them do not arise out of the joint accounts of the bond houses. Such cases have their origin in almost any other form of endeavor carried on by joint effort. In its legal aspects the joint account comes under the special classification of "Joint Adventure." So far as it is discussed in general treatises on the law it is dealt with in works on "Partnership." Even the most extensive of these works, however, hardly more than mentions it.

A joint adventure, or "joint account," as the bond houses call their particular form of

joint adventure, may, indeed, properly be considered as a special form of partnership, and the legal considerations governing it may be considered as differing from those of the general law of partnership only as the special nature of joint adventure requires them to differ.

Frequently the cases point out, by way of stating a general principle to cover some special point in issue, that, though a joint adventure is not in a strict legal sense a co-partnership, the rules of law applicable to the partnership relation govern the rights and duties of those jointly engaged.

Ordinarily, in the cases of joint adventure the rules of a general partnership apply to the questions involved, and the court properly limits itself to the remark that, though a joint adventure is not fully a copartnership, the law of partnership applies. The court has no occasion to discriminate more precisely. However, some of the distinctions are interesting and important. Since the general treatises afford little help to a clear understanding of the law of joint adventure as applied to the joint account, it may be helpful to present a brief discussion of some of the legal issues involved in the entering into, and conduct of, a joint-account transaction.

Though in applying the analogy of the

law of partnership to joint adventurers the courts are careful not to say that a joint adventure is a partnership, nevertheless, the seeker finds upon a search through the cases that the precise differences from a partnership are somewhat elusive.

The essential partnership nature of joint adventure is dwelt upon because of its bearing on the matter of liability. Members of a joint account have, as to third parties, — that is, as to those with whom the account deals, — the general liability of partners. A stipulation in the agreement for the account that they are not acting as partners has simply the effect of calling attention to the fact that the transaction is a joint account, with whatever limitations on the general law of partnership such fact may imply.

The most important difference in the legal aspects of a joint adventure and a partnership seems to lie in a limitation, in the case of the joint adventure, of the doctrine of agency as applied to partnership. Speaking broadly, a person dealing with any member of a partnership may consider that member the agent of the partnership for all purposes of the partnership business. Any partner can bind his copartners in any transaction within the scope of the partnership. Obviously the scope of a joint account is limited to the specific pur-

poses of the account. Apparently any one dealing with the syndicate — that is to say, with a party to the joint account purporting to act on behalf of the joint-account syndicate — is bound to know the specific purposes of the syndicate transaction and cannot hold the syndicate liable on an undertaking outside the scope of those specific purposes. This doctrine is carried far enough to involve, perhaps, a real distinction between a joint adventure and an ordinary partnership formed to carry on a business of a specific and limited kind.

Suppose our corporation, instead of having \$5,000,000 of bonds to sell, must, in order to meet its capital requirements, dispose of \$25,000,000. Our syndicate of Brown & Company, Smith & Company, Jones & Company, and Robinson & Company may be in a position successfully to negotiate the purchase of the issue, but may not want to undertake to sell so large an amount. Distributing such an issue, to its ultimate lodgment in the hands of permanent investors, involves a really tremendous effort. Because one can say “a million dollars” as readily as saying “a hundred dollars,” any sense of the real magnitude of the sum involved in the larger figure easily eludes one. If the permanent investors should each take \$5000 of the bonds, on the average,

the bankers would have to find 5000 investors who may be induced to prefer this particular investment rather than one of a hundred of others equally available at the same time. The number of people who are in a position to invest \$5000 at one time is very limited. So, though a few financial institutions may buy the bonds in larger blocks, probably the \$5000 average is too high rather than too low.

Our syndicate, however, does not want to lose the opportunity to do business. In order to undertake this particular piece of business it must secure coöperation on a much larger scale than is afforded by these four houses working together. They must get the full advantage of the clientèles of numerous houses.

In order to get this larger coöperation more houses must be taken into the syndicate. But Brown & Company and their associates feel that they can get some return and are entitled to it for their business advantage in being in a position to buy the bonds and for their work in organizing a syndicate of the size necessary to handle so large a transaction. So they first decide to form a syndicate composed of the four houses in order to purchase the bonds from the corporation and to sell them to another syndicate which they will organize. Of course, too, if they actually

effect the purchase before they complete the organization of the second syndicate, they are assuming a risk for which they are entitled to compensation.

To distinguish the general nature of the two syndicates, we call the first a "joint account" and will call this second syndicate an "underwriting syndicate." It would be in the interests of clear expression not to use the term "syndicate" in connection with joint accounts, but to confine its use to the underwriting. As a matter of fact, on the street these terms are used interchangeably, with a tendency, however, to make the discrimination we have indicated between the terms "joint account" and "underwriting." On this matter of nomenclature I have remarked elsewhere:¹

The term "joint account" implies, in securities transactions, an undertaking entered into by the parties for the purchase and sale of securities, in which the rights and liabilities of all the parties are essentially the same in proportion to their interest. This is in distinction from an "underwriting syndicate" in which the parties are not on the same basis, or rather, in which, strictly speaking, there are two accounts. It seems desirable to reserve the terms "syndicate" and "underwriting

¹ Report by the writer to the Investment Bankers' Association of America on "Joint Account Letters and Forms, and Some Considerations of the Law of Joint Account."

agreement" for this form of undertaking and use only the words "account" or "joint account" for undertakings of the kind discussed here. It seems also desirable to keep the terms "subscribers," "subscriptions," and "underwriting" for the syndicate agreement and use the terms "members" and "participations" for the joint account.

We will assume that the original syndicate bought the bonds for 95.50 as before, and we will also assume that it sells them to this second syndicate at an advance of one point, or at 96.50. Again warning should be given that any figures stated in the discussion must not be taken as typical. In practice the figures vary widely and in the discussion specific figures are stated merely for the sake of clearness. In organizing the second syndicate the members of the original group, in becoming members of the second, must clearly state that they are making this profit. Since the relationship of parties to a joint adventure is of a fiduciary nature, they must exercise the utmost good faith toward each other. One may not make a secret profit. So the statement of the profit of the original account regularly appears in the underwriting syndicate agreement. Members of the original account could not well avoid, if they would, making substantial subscriptions to the un-

derwriting. They must do this to show their belief in their own undertaking. Though they might have the fullest confidence that the undertaking by the second syndicate would result in all the anticipated profits, they might, for perfectly good and proper reasons, prefer to stay out of the underwriting. They might be able to employ their capital in some matter that promised better returns than those to be anticipated from the most successful result of the underwriting. Naturally, however, the people who are invited to subscribe would be suspicious of the proposal if the people who are extending the invitation failed to be among those subscribing.

Although joint-account agreements are ordinarily informal, — just an exchange of letters, as already indicated, — underwriting agreements, on the other hand, are ordinarily formal. The number of subscribers makes the full formal statement more important for the avoidance of misunderstandings. Generally the houses organizing the underwriting syndicate hand, or mail, to those whom they are inviting in, a copy of the subscription agreement, and each subscriber signs a separate copy. It will not do, in discussing syndicates, or indeed almost any other topic in the subject of "Corporation Finance," to speak in general terms without some express reserva-

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tion. Sometimes underwritings of very large amounts, involving a considerable number of subscribers, are the most informal. When it becomes known that a syndicate is about to purchase a large issue of securities, representatives of other houses, which enjoy business relations with one or more of the purchasing houses, are likely to telephone and ask that they be put down for a certain amount. This subscription will generally be acknowledged by mail, but the letter will not state any of the terms of the agreement other than naming the subscription price.

If the subscriptions received total more than the amount of the whole issue, some or all of the subscribers will be scaled down in the "allotment." By "allotment" is meant the formal acceptance of the subscription. The subscription blanks which have been sent out contain a stipulation reserving the right to reject all or any part of the subscription. In legal terms sending out the application blanks is a mere bid for an offer; signing and sending them in constitutes the offer. Since the offer is for all or any part of the amount applied for, the allotment of less than the full amount constitutes an acceptance in accordance with the terms of the offer and completes the contract.

In forming the underwriting syndicate the

members of the original syndicate become managers of the second syndicate. Or it may be that only one of the members of the joint account, or first syndicate, becomes manager of the underwriting syndicate. The manager of the underwriting syndicate has much more power than the manager of the joint account. For one reason this is necessary because of the larger numbers of the second group. An expression of opinion cannot be had so readily from so many people. The second syndicate may have up to say two hundred subscribers. Since the size of the issue makes the whole situation more difficult to handle, some central authority must have the power to act quickly. The group that formed the joint account presumably comprises houses with more capital and wider reach. They are more powerful houses and are in a position to impose terms.

The power of the manager or managers of an underwriting syndicate often extends to making or changing the selling price, and in a general way the manager or managing group directs the policy of the business as well as takes care of the details. As one of the cares of the position the manager will have the duty of protecting the market. Until the syndicate has disposed of the entire issue, it is of course essential that no bonds should be

offered for sale at less than the price at which the syndicate offers them. If sales in the general market are reported at a lower price the syndicate naturally cannot command the price it has set.

Since the syndicate sold in the first place at its price all the bonds that have been sold, one might well inquire who has any bonds of the issue to sell at a lower price. People often purchase bonds on a new offering in the belief that the particular bond at the price, with the particular issuing houses back of it, under the existing general conditions of the market, will be in such demand that the issue will all be purchased at once and the price in the general market will go up. When such people have purchased and have seen that the securities were not all sold at once on issuance, they know that their speculative hopes will not be realized promptly. Since they bought as a speculation and cannot make the immediate profit, they prefer to sell at once at such loss as may be necessary rather than keep their capital tied up and run the risk of further loss. So they promptly turn around and offer their bonds on the market. Such a throwing of securities back on the market makes one of the dangers of the syndicate transaction. Avoiding such a situation so far as possible, and taking care,

of it when it does arise, comprises a large part of the strategy of any undertaking to market an issue of securities. When securities are offered at less than the syndicate price, the only thing the managers can do to protect the market is to buy in such securities. The managers will usually try to trace the source of the selling and generally will succeed in the endeavor. They will make a mental note of who the seller is and when he wishes to purchase securities of some future issue which is oversubscribed the managers will not favor him in allotting the bonds.

Some one may wonder how the managers can find out who the seller is. Ordinarily such a seller would place his securities in the hands of a broker to sell and the broker would not disclose — “give up,” as the phrase is — the name of his principal. But every bond has printed on it the particular number it bears in the issue. When the managers delivered the bonds to the selling house they noted in their books the numbers of the bonds delivered. In turn the selling house noted the numbers of the bonds it delivered to each purchaser. So when the managers buy in some bonds to protect the market they can look for the numbers and always trace the transaction through to the first purchaser. If the first purchaser is a broker, who has just

passed the bonds on to his principal and taken the broker's commission to which he is entitled, he may, and probably will, refuse to name the principal. The broker has run into trouble through his dealings with his principal and next time may be a little more cautious in dealing with him. Besides the check the managers have through the numbers on the bonds, they may trace the source of the selling through many indications readily apparent to a man skilled in the practices of the street.

Some recent syndicate agreements have sought to guard against speculative purchases by providing that the selling house shall be responsible for the character of its sales. Under such an agreement, if a house has made a sale to a man who turns out to be a speculator who throws his securities back on the market, the syndicate manager has the authority to buy the bonds in at the price at which they are offered, turn them back to the selling house, and charge up against the selling house, as a loss to be borne by it, the difference between the price at which the managers bought the bonds in and the full price at which the syndicate holds them for sale. The possibility of having to bear the full burden of such a loss would tend to make a member house very careful to get the bonds it

sells into the hands of purchasers who are buying for investment. At the time of writing one cannot foresee whether this experiment will succeed and the provision be increasingly used, or whether the difficulties of the situation are such that a provision of this kind will come to be regarded as undesirable.

Very large investors in securities may become members of joint accounts or subscribe to underwritings in order to get the advantage of the lower price in their purchases of securities. It is understood that these participations are for investment. When the syndicate takes delivery of the securities from the issuing corporation, such participants pay for and take up the amount of their participation. Such a transaction is called a "withdrawn participation." Whatever the arrangement as to other participants, as to an individual or institution taking a withdrawn participation, the transaction would be a strictly divided or limited liability account. The other members of the syndicate get the advantage of having that amount of the securities taken absolutely out of the market. Owing to certain abuses, which it was believed had crept into the practices of insurance companies in taking advantage of such participations, the State of New York made it illegal for them to engage in syndicate transactions.

We have discussed the formation of the underwriting syndicate as if there were always two syndicates whenever an intermediary makes, or attempts to make, a profit between the price received by the corporation and the price paid by the underwriters. Really, one of the several largest of the investment banking houses — the few investment bankers sometimes called the wholesaling houses — often occupies the position we have described as taken by the first syndicate in the underwriting transaction. These wholesaling houses occupy their position by reason of their capital, their credit resources, and the influential positions they occupy both with the large issuing corporations and with the dealers in securities, who are in direct touch with nearly all the frequent buyers of securities for investment in the country. They also have foreign connections in one or more of the European financial centers, — London, Berlin, Frankfort, Amsterdam, Paris, — and have been able to take some, or all, of an issue out of this market entirely.

Usually, on the sale of the securities held by an underwriting, the syndicate advertises them for sale in several cities simultaneously. Often these advertisements say that on such a day up to such an hour, or up to such an hour of such a day, subscriptions will be

received for the purchase of securities of the issue. Either phrase means that subscriptions will be received immediately and recorded. If, by the stated hour, the applications are greater than the amount, the issue is oversubscribed. The syndicate managers then proceed to allot the securities. Just as in the case of the allotment to the subscribers to the underwriting syndicate, the managers may not allot, in exact proportion to the subscriptions, to those who have applied to purchase the securities. The managers will especially favor the smaller subscribers. The presumption is greater that they are purchasing for permanent investment rather than for speculation. Usually they make the best possible purchasers of securities from the distributor's standpoint, because they buy to keep. The securities are lodged away and only infrequently will come out on the market to add to the floating supply and to tend to keep the price down. The distributors must keep the general market price up to the price they are asking while they are distributing the securities. They earnestly want the price to stay up and, better, to advance after they have sold the entire issue and have nothing further to gain or lose directly. But these investment bankers want to bring out an issue of securities another day, and nothing

is a better silent selling argument than the fact that the clients to whom they are appealing made money from an earlier purchase. So, in making the allotments of an oversubscribed issue, the managers favor those whose purchases will make for the best future for the issue.

Sometimes when the market is strong and a new issue catches the attention of the income-buying public as a particularly attractive investment, many people will surmise that the issue will be largely oversubscribed, with a consequent scaling down in the allotments; and in order to get as large an amount as they really want, they will subscribe for a much larger amount of the security than they want, in order to get, if possible, approximately the amount they actually do want. Such applications, representing an anticipation of scaled allotments, account for most of the very large oversubscriptions on the public offering of securities. If the syndicate fails on the public offering to sell all the bonds, the business takes the usual course already described. Some time necessarily intervenes between the agreement to purchase, when the price is agreed to on existing market conditions, and the offering of the bonds to the public. Even if the purchasing bankers correctly estimated market condi-

tions at the time of the purchase, conditions sometimes change rapidly, and on the offering the public may take only a small percentage of the issue. An attempt to sell the bonds at the syndicate price may result unsuccessfully, and the subscribers to the underwriting may have to take up nearly all the bonds and ultimately sell them at heavy losses.

Sometimes the issuing corporation appears as offering the securities on the public sale, or perhaps the syndicate managers on behalf of the corporation. In such a case the subscribers to the underwriting, instead of being in the position of owners of the issue, and selling it on their own account, are in the position of guarantors who are insuring the success of the sale. If the public does not buy all the bonds the subscribers to the underwriting must take up the unsold balance as purchasers. The term "underwriting" accords more strictly, perhaps, with the position of a guarantor syndicate insuring the success of the sale. The street uses it, however, without any discrimination between the two methods of handling the transaction. Both methods come to the same results.

Our discussion of syndicate transactions has assumed some specific figures for the sake of clearness. One must not suppose, however, that amounts alone govern the adoption of

the method of handling the transaction and determine whether only one banking house shall be concerned, or more than one, or whether there shall be one or two syndicates between the corporation and the investor. The size of the issue in relation to the capital, selling power, and other commitments of the banking house or houses does determine. An amount of \$100,000 of securities or less might well afford the basis of a joint-account transaction. With only a little more than that amount an underwriting syndicate might take the securities over from an original joint account. Sometimes a banking house which has subscribed to an underwriting may proceed to form a joint account of its own to handle its allotment of the issue. Any discussion can give only a general idea of these joint undertakings for the sale of securities. They shade into each other in a way that eludes precise description. Their purpose, the one thing common to all, is to join financial resources and selling power sufficient to provide the amounts of capital required from time to time by the magnitude of economic enterprises.

CHAPTER IV

LISTING ON THE STOCK EXCHANGE

IF a corporation should list an issue of its securities on the Stock Exchange, it would not, merely by so doing, provide any funds for itself. So far as listing alone is concerned the corporation by the mere authorization of the securities has accomplished as much toward procuring capital. Listing securities does not sell them; it only provides one means for making a market in them; that is, affording an opportunity for holders to sell them after they have been sold in the first instance.

We have already discussed the importance of having a market in an issue of securities. An active course of Stock Exchange dealings affords a quick and close, a free and open market, practically the best market possible. For reasons stated in the first volume (p. 205) the New York Stock Exchange offers little advantage for creating a market in small issues, and purchasers of securities of small issues do not expect to have them listed there. Investors do expect to see large issues listed on the Exchange, and with the largest issues expect an active course of dealings there. So, when bankers are offering a large issue for

sale, they announce that application has been made to list the issue on the New York Stock Exchange.

They have not already listed it at the time of offering the security for sale for one or both of two reasons. The undesirableness of having the security listed during the time the bankers are engaged in selling it has already been indicated. Such a listing offers a competitor a special advantage in trading purchasers out of the security, and a special opportunity for the speculative purchaser to close out his speculation. If the issue is on the Stock Exchange list while the banker still has part of the issue to sell, its appearance there will greatly increase the difficulty of protecting the market. At the same time it is possible for the bankers, especially with a somewhat speculative issue, by developing a course of trading, to utilize the Stock Exchange in disposing of securities. By buying in enough to protect the market, and by taking advantage of the buying of others at or above the price at which the bankers are willing to sell, they may dispose of a large part of an issue by means of the Stock Exchange market.

Besides the difficulty of protecting the market as a cause for delay in listing, the bankers and their counsel may not have had

an opportunity to bring the matter before the Stock Exchange authorities in time to have the issue listed before offering it for sale. As we shall see before the discussion is ended, the preparation of an application for listing requires a large amount of work in itself. All the other work of preparing the issue, getting the proper resolutions of the corporation, drawing up the trust deed, may have kept counsel under such pressure that they could not attend to any further matters. The burden of meeting the listing requirements is likely to fall on them. The Stock Exchange authorities require that applicants for listing submit specimens of all securities to be listed. It takes some time for the engraving concern doing the mechanical work of preparing and printing the issue to present a specimen for the Exchange authorities to examine. This would be true even for an interim certificate, or subscription receipt as the Stock Exchange Committee terms it, representing the definitive security while it is in course of preparation. Bankers frequently utilize such interim certificates, it may be remarked, to make delivery when they offer the issue for sale. Often the definitive certificate of stock, but more especially the definitive bond, — that is to say, the final piece of paper to represent the security, — cannot be prepared in time

for the bringing out of the issue. Time is of the essence when the bankers are bringing out a new issue. Financial conditions often change rapidly. Capitalists may be in an investing mood for the present but in the immediate future may refuse to purchase anything. The bankers must take no chances of losing their market. This fact explains the interim certificate, and would be sufficient often, if there were no other reason, to explain the failure to have the issue listed by the time it is brought out.

Once the issue is sold and the listing is complete, the bankers will have to watch the market until they are sure that the course of dealings is well established. During the process of sale they will have done everything possible to build up a market as described in the preceding discussion of raising funds through the banking houses. Building a market, in the sense of establishing a course of trading, is much like building an arch; if the process is complete the market will support itself. A buying demand will exist sufficient to meet without breakdown any pressure to sell. The bankers who brought out the issue can now welcome the speculators; every speculative purchase and sale means one more transaction to help make the market more active and therefore more stable.

Though this is not the place to discuss the function of speculation, we may remark that the result of speculation resembles the effect of a gyroscope in its stabilizing power.

Listing does not cost heavily in the direct charge imposed by the New York Stock Exchange. The Exchange exacts a fee of only \$50 for each \$1,000,000, or fraction, of the par value of securities, or, in the case of stock without par value, \$50 for each 10,000 shares. The expense of complying with the requirements of the Exchange in the furnishing of information would substantially increase the total cost. Besides the costs, which, once met, do not recur, the corporation will have to bear the continuous expense of maintaining a transfer agency and a registrar of transfers in the Borough of Manhattan, New York City.

From the standpoint of the work of the Exchange this requirement of maintaining a transfer agency and a registrar of transfers conveniently near is most important. With the volume of transfers necessary as a result of active dealings it would be impossible to put through the business if every time a transfer were required the certificate had to be sent out of town. This applies with greater force to the American exchanges, with their daily settlements, than to the

foreign exchanges, with their settlements at longer periods. Since any real Stock Exchange activity in the securities of a corporation requires an organization to take care of the transferring anyway, the matter of the location does not work greatly to the disadvantage of the corporation. Some of the transfer agencies for the largest and most active issues are considerable, and, in active times, very busy organizations. Their work and problems deserve a more extended description than we have space for. It is hardly necessary to say that the Stock Exchange sees to it that the registrar of transfers forms no part of the same organization as the transfer agency. A trust company regularly attends to the duties of registrar. If transactions are not numerous, another trust company may perform the duties of transfer agent. Principal and interest of listed bonds and dividends on stock must be made payable at the office of the transfer agency. The corporation must not change its transfer agency or its registrar of stock without the approval of the Stock Exchange authorities.

The corporation must agree to publish and submit an annual report to its stockholders at least fifteen days before its annual meeting. This report must show an income account and balance-sheet and an income account and

balance-sheet of all constituent, subsidiary, owned, or controlled companies, and must contain a statement of the physical condition of the corporation. This requirement of annual publicity, together with the amount of information demanded at the time of listing, has proved an obstacle to the listing of the issues of some corporations. Doubtless the desirability of listing has overcome the unwillingness of the managers of other corporations to furnish such information. The corporation must agree also not to dispose of its stock interest in any subsidiary, owned, or controlled company, or to allow any constituent, subsidiary, owned, or controlled company to dispose of a stock interest in other companies, except for retirement and cancellation, unless under existing authority or on direct authorization of stockholders of the holding company. If the corporation issues any stockholders' rights it must notify the Exchange, and must make all rights transferable, payable, and deliverable in the Borough of Manhattan.

The Stock Exchange demands great care in the mechanical execution of securities as a prerequisite to listing. The reader will find some discussion of the importance of these requirements at page 212 of the first volume. The Exchange requires that securities must

be engraved and printed in a manner satisfactory to the committee on the stock list from at least two steel plates.

1. A border and tint plate from which a color should be printed underlying important parts of the face printing.

2. A face plate containing the vignettes and descriptive or promissory parts of the document. This should be printed in black, or in black mixed with color.

Everything must be done to make as effectual security against counterfeiting as possible. Classes and denominations of securities should be made distinguishable by printing them in different colors. The entire amount of the capital stock of a corporation which has listed its stock on the Exchange must be transferable at the transfer office in the Borough of Manhattan. If a corporation also makes a transfer of its shares in other cities, all certificates must, nevertheless, be interchangeable and identical in color and form. The corporation must not make any change in the form of a security without the approval of the Stock Exchange authorities.

The Committee of the Governing Board of the Stock Exchange, which considers all applications for listing and reports on them to the Board, is called the "Committee on Stock List." Besides the requirements already

stated, in the case of bonds, it also makes the following stipulations: —

The panel, coupons, and denomination of bonds must be engraved and printed in a manner satisfactory to the Committee; coupons must bear a vignette.

The text of bonds should recite conditions of issuance, terms of redemption, by sinking fund or otherwise, default, interchangeability or exchangeability of coupon and registered bonds, and conversion into other securities.

Registered bonds must carry a power of assignment in such form as the Committee may approve.

The Committee recommends that registered bonds be made interchangeable with coupon bonds.

Registered bonds interchangeable with coupon bonds and coupon bonds exchangeable for fully registered bonds shall bear a legend reciting the fact.

Coupon bonds issued in denominations of less than \$1000 should provide for exchangeability into coupon bonds of \$1000, the smaller bonds to bear a legend reciting such privilege.

Registered bonds made such by detaching coupon sheets are not eligible for listing.

In the case of stock the Committee makes these requirements: —

The border and tint plate for one-hundred share certificates of stock shall have said denomination engraved thereon in words and figures;

the plates for smaller amounts shall bear some engraved device whereby the exact denomination of the certificate may be distinctly designated by perforation; also conspicuously upon the face the words, "Certificate for less than one hundred shares."

Certificates for common and preferred stock shall recite preferences of the preferred.

Certificates of stock should recite (1) ownership; (2) par value; (3) whether shares are full paid and (4) non-assessable; (5) terms of redemption; (6) preference as to dividends; (7) distribution of assets upon dissolution or merger; (8) voting power, or (9) other privilege; and must (10) bear the following legend: — "This certificate is not valid until countersigned by the transfer agent, and registered by the registrar."

Though a detailed statement of the information required by the Exchange will make somewhat tedious reading, besides conveying the precise information, the reader can make it serviceable by way of a partial review of the subject of "Corporation Finance." Requirements stated are as of the 1st of January, 1916. The applicant for listing must file the following papers: —

For stocks: —

1. Seven copies of charter, with amendments to date, one copy attested by the Secretary of State where incorporated or other proper public authority.

2. Seven copies of by-laws, with amendments, one copy attested by secretary of corporation.

3. Seven copies of leases and special agreements, one copy of each attested by secretary of corporation.

4. One copy of resolutions of stockholders and directors authorizing issue, each attested by secretary of corporation.

5. One copy of resolutions of board of directors or executive committee, attested by secretary of corporation, authorizing, by name, official to appear for listing securities.

6. Opinion of counsel (not an officer or director of the corporation) as to legality of (a) organization, (b) authorization, (c) issue, and (d) validity of securities.¹

7. Detailed distribution of securities.

8. One copy of resolution appointing transfer agent and registrar, attested by secretary of corporation.

9. Certificate of proper public authority for issue.

10. Certificate of registrar of amount of securities registered at date of application.

11. Report of a qualified engineer covering actual physical condition of property of recent date.

¹ The Committee will not accept the opinion of an officer or director of an applying corporation nor of a firm in which the officer or director is a member, as counsel on any legal question affecting the corporation; nor will it accept the opinion of an officer or director of a guarantor corporation on any legal question affecting the issuance of guaranteed securities.

12. Map of property and contemplated extensions.

13. Specimens of all securities to be listed.

For bonds:—

14. All papers required for listing stocks and also seven copies of the mortgage or indenture, one copy (a) certified to by trustee, (b) with copies of all certificates of proper recording.

15. Trustees' certificate.

16. If bonds are convertible into stock, certified copies of (a) action of stockholders, and (b) of directors, authorizing issue and reservation of stock specifically for conversion.

17. Certificate of disposition of securities redeemed or refunded.

18. Certificate as to collateral deposited.

19. Certified copy of release or satisfaction of underlying mortgages.

For securities of reorganized corporations:—

1. All papers required above for listing stocks or bonds, as the case may be.¹

2. Certified order of court confirming sale on foreclosure or other authority for reorganization.

3. Certified copy of plan of reorganization.

4. Income account; balance-sheet at close of receivership, if available.

5. Balance-sheet at date of organization.

¹ Opinion of counsel shall also state that proceedings have been in conformity with legal requirements, that title to property is vested in new corporation, and is free and clear from all liens and encumbrances, except as distinctly specified; and also as to equities of securities of predecessor corporation.

For additional amounts: —

1. Nos. 4, 5, 6, 7, 9, 10 of papers required for original listings.

2. Nos. 1, 2, 3, 8, and 11 of said papers for stock, if any changes have occurred therein since last listing.

3. Nos. 14, 15, 16, 17, 18, and 19, of said papers for bonds, if any changes have occurred therein since last listing.

4. Certified copy of proper public authority for increase.

For certificates of deposit, voting trust, etc.: —

1. Papers required above for listing stocks or bonds.

2. Certified copies of any legal proceedings and court orders.

3. Seven copies of deposit or trust agreement, one certified to by proper authority.

4. Seven copies of circulars, issued by trustees or committee, one certified to by proper authority.

5. Amounts deposited.

6. Detailed distribution.

Besides filing the specific papers just detailed, the petitioner for listing must in his application convey the following information: —

A. Title of corporation.

B. (1) Date of organization; (2) name of State authorizing incorporation.

C. (1) Duration of charter; (2) and of charters

of constituent, subsidiary, owned, or controlled companies.

D. (1) History of corporation; (2) if a consolidation, merger, or reorganization, history of predecessor, and constituent, subsidiary, owned, or controlled companies, or firms, showing (a) names, location, and stock issues; (b) conditions leading to new organization.

E. (1) Charter rights; (2) nature of business, character and amount of annual output, number of employees; (3) special rights or privileges granted directors by charter or by-laws.

F. (1) Whether capital stock is full paid; (2) non-assessable; and (3) if personal liability attaches to shareholders.

G. (1) Issues, dividend rate, and par value; (2) total amount of each, authorized and issued; (3) increases and authority therefor, including (a) action by stockholders, (b) by directors, and (c) by public authorities, etc.; (4) amount unissued, (a) options or contracts on same, (b) specific reservation for conversion.

H. If preferred stock; (1) whether cumulative or non-cumulative; (2) preferences, including (a) voting power; (b) dividends; (c) distribution of assets on dissolution or merger; (d) redemption.

I. Voting power of obligations of debt.

J. (1) Dividends heretofore paid; (2) by predecessor, or constituent, subsidiary, owned, or controlled companies; (3) earnings for preceding five years, if available.

K. Description of property (1) owned in fee; (2) controlled; (3) leases; (4) franchises; (5) location, nature, and acreage; (6) railroads, mile-

age completed, operated, and contemplated, and trackage rights; (7) traffic agreements; (8) equipment; (9) character of buildings and construction; (10) timber, fuel or mining lands, water rights (see paragraphs T to Z, below).

L. (1) Purpose of issue; (2) application of proceeds; (3) amount of issue for securities, contracts, property, description and disposition of securities acquired; additional property acquired or to be acquired, with particulars, as required by paragraph K.

M. (1) Mortgage, and (2) other indebtedness, (*a*) date of issue, (*b*) maturity, (*c*) interest rate, (*d*) redemption by sinking fund or otherwise; (3) similar information regarding mortgage and all indebtedness of constituent, subsidiary, owned, or controlled companies.

N. Other liabilities, joint and several, (1) guaranties, (2) leases, (3) traffic agreements, (4) track-age agreements, (5) rentals, (6) car trusts, etc.; (7) terms of each, and provision for payment.

O. Fiscal year.

P. Financial statements; (1) income account of recent date for at least one year; (2) balance-sheet of same date; (3) similar figures for predecessor, constituent, subsidiary, owned, or controlled companies; (4) final balance-sheet; (5) when reports published; (6) for corporations consolidated within a year, income account and balance-sheet of all companies merged and balance-sheet of applying corporation.

Q. Names of (1) officers; (2) directors (classified), with residence; (3) transfer agents, and (4) registrars, with addresses.

R. Location of principal and other offices of corporation.

S. Place and date of annual meeting.

In addition to the above, corporations which are owners of mines must recite: —

T. Patented and unpatented claims, by numbers.

U. (1) A geological description of the country; (2) location and description of mineral and other lands; (3) ore bodies; (4) average value; (5) character of ore; and (6) proper methods of treatment.

V. History of prior workings, showing (1) results obtained; (2) production each year.

W. (1) Ore reserves compared with previous years; (2) estimate of engineer as to probable life of mines; (3) probabilities by further exploration.

X. (1) Provisions for smelting and concentration; (2) cost of (a) mining, (b) milling and smelting, (c) transportation; and (3) proximity of property to railway or other common carrier.

Y. Income account, (1) receipts; (2) expenditures; (3) disposition of income.

Z. Properties in process of development; if income account not available, what guaranties for working capital and for completion of development.

Bonds.

An application for an original listing of bonds shall recite all information required for listing capital stock, and

A. (1) Amount, denominations, and numbers; (2) full title; (3) amount authorized and out-

standing, authority therefor, including (a) action by stockholders, (b) directors, and (c) public authorities, etc.; (4) whether bonds are coupon (registerable as to principal) or registered, interchangeable or exchangeable; (5) exchangeability or convertibility into other securities, and terms.

B. (1) Date of issue and maturity; (2) interest rate; (3) places at and dates for payment of interest and principal; (4) where registerable or transferable; (5) kind and standard of money, and options; (6) tax exemption; (7) whether redeemable or purchasable in whole or in part, showing (a) dates, (b) price, (c) duration of published notice, (d) disposition of redeemed or purchased bonds.

C. Mortgage or indenture provisions for (1) serial issues; (2) values in United States gold coin, issuance in foreign languages and that the English version governs; (3) terms of exchangeability of bonds payable in foreign places for bonds payable in United States.

D. (1) Security-mortgage, indenture of trust, or other agreement; and, (2) liens; (a) properties covered, (b) mileage of railway lines, (c) buildings, (d) equipment, (e) securities, (f) rights, (g) privileges, (h) titles, (i) franchises, (j) leases, etc.; (3) other liens covering same or any part of same properties; (4) guaranty and terms.

E. (1) Names and addresses of trustees, and any unusual additions to or limitations of powers; (2) provision for declaration of principal due and payable in event of default of interest or other default, and waiver; (3) percentage of outstanding bonds controlling trustee.

F. Purpose of issue and application of pro-

ceeds, similar to that called for by paragraph L of the "Requirements for Listing Stock."

G. Disposition of bonds refunded and mortgage securing same.

Requirements for listing of additional amounts.

Refer to previous applications and last application by number and date; and recite: —

A. Title of corporation and name of State authorizing incorporation.

B. (1) Securities applied for; (2) amounts authorized; (3) authority, including (a) action by stockholders, (b) by directors, and (c) by public authorities, etc.

C. (1) Dividends (2) by constituent, subsidiary, owned, or controlled companies, since previous application.

D. (1) Purposes of issue; (2) application of proceeds; (3) amount, description, and disposition of securities exchanged for new issues; (4) additional property acquired or to be acquired, with particulars as required by paragraph K of the "Requirements for Listing Stock."

E. Income account and balance-sheet of recent date, with similar figures for constituent, subsidiary, owned, or controlled companies.

F. Names of officials, location of offices, place and date of annual meeting, as covered by paragraphs, Q, R, and S of "Requirements for Listing Stock."

(Note) Increases of capital stock are not eligible for listing until thirty days after notice of increase, or proposed increase, has been given the Exchange; increases of stock by conversion of listed bonds (of which notice shall be given the Exchange) may be immediately listed by the Committee and registration authorized.

CHAPTER V

CORPORATE INCOME

THIS discussion of corporation finance so far has assumed enough knowledge of accounting for an understanding of the elementary terms of the balance-sheet and the income account. The brief consideration of the subject in this chapter is presented for the benefit of those who do not have this preliminary acquaintance with the elements of accounting. The reader should not assume, however, that the statements made in this chapter are intended to present a model of accounting practice. The immediate discussion attempts only to give, as directly and briefly as possible, enough of an explanation to enable the reader to grasp the significance of corporation accounting in relation to corporation finance.

Though we have just used the term "corporation accounting" we must not assume that the accounting of corporations differs in any essential way from the accounting of any other method of conducting business. The nature of the business governs the method of accounting rather than the nature of the proprietorship; that is, whether the proprietor

is an individual, a partnership, or a corporation. The seeming though not real exception should be made of the holding company. This presents some special aspects of income which we shall discuss in the next chapter.

Throughout our discussion so far we have used an old and still the more familiar nomenclature of accounting, and made statements in a condensed form. For the purpose of making easy the process of comparison and presenting the financial discussion in its simplest form this has been desirable, and for these reasons the old condensed form of statement is still the one generally used in presenting the results of accounting to show conditions for the purpose of financing the capital account.

Our income account so far has presented only the items —

Gross Income.

Operating Expense.

Net Income.

Fixed Charges.

Surplus Available for Distribution.

Only the slightest thought is needed to see that such a statement presents a totally inadequate analysis of income and expenditure on account of conducting a business, and that elements of a very different nature must be included under a single head. With this condensed statement all sources of income of

whatever nature must be included under the head of "Gross Income." Obviously, however, if business for the manufacture of machinery includes the ownership, for some special reason, of \$100,000 New York City 4 per cent bonds, the \$4000 a year of income from this source is a very different thing from the money received for the sale of machinery. One can get no complete understanding of the business situation without recognizing the distinction and knowing such a situation when it exists.

The chapter in the first volume on "Trading on the Equity" set out the varying natures of gross incomes on account of the nature of the business producing the income, and made the general assumption for the purpose of the discussion that all the income of the corporation came as a result of conducting the business. If the corporation is wholly or in part a holding company, the nature of the income is a very different thing. We shall discuss this more at length in the next chapter.

The next item of operating expense obviously must include even more diverse elements. For example, lacking a special head for "Taxes," moneys paid out for that purpose must come under the head of "Operating." Yet the difference between an expenditure imposed on the business by the State and

entirely outside of the control of the management needs no further pointing out. If the nature of the business is manufacturing, and the income account has no other head, the cost of the raw material must come under the head of "Operating Expense." Again, the essential difference between the cost of the material and the cost of converting it into the finished product needs no elucidation beyond the mere mention. This is a distinction that applies as between a manufacturing business and a transportation or other public service business. The distinction between a merchandising business, in which the very goods which are bought are sold without any change in form, is even greater than the distinction between a manufacturing business and a public utility.

Another distinction in the nature of expenditures, which needs to be made to get an understanding of the business situation involved, is the difference between the cost of carrying on the operations of the business itself and the cost of maintaining the plant in a condition for the efficient conduct of the business, and generally the maintenance of the capital investment unimpaired. This distinction is usually made in accounting as between the cost of "Conducting Operations" and the cost of "Maintenance."

Fixed charges do not present the same kind of essential differences. They include any costs which the management of the business cannot cut off of its own volition. The management must meet them, and they do not diminish on a diminishing scale of business. Interest and rentals are the essential fixed charges; both incurred for the sake of additional capital in the business on the general principles discussed in the chapter on "Trading on the Equity."

With these remarks we have our income account recast into the following form: —

OPERATING REVENUE.

(Classified according to the kinds
of business carried on.)

OPERATING EXPENSE.

Conducting Operations.
Maintenance.

NET OPERATING REVENUE.

TAXES.

INCOME FROM OTHER SOURCES.

DEDUCTIONS FROM INCOME.

Interest.
Rentals.

AVAILABLE FOR DIVIDENDS.

DIVIDENDS.

SURPLUS.

CONTINGENT LIABILITIES.

Such a form of accounts applies especially to a corporation conducting a transportation business. It is a skeleton adopted from the form of report required by the Interstate

Commerce Commission. It would present the essential facts of a public service enterprise of the nature of an electric light or power company, a telephone or telegraph company. A gas company has some of the aspects of a manufacturing enterprise.

In our previous discussion we have taken for our operating ratio — that is, the proportion of earnings consumed in the cost of operating — the whole of operating expenses including the cost of conducting operations, the cost of maintenance and taxes to boot. As a single figure summarizing certain totals this percentage serves a useful purpose. For further analysis we need to know about the items included in the total. To form conclusions about the combined efficiency of the management and the plant, we need to know specifically the cost of conducting operations. We say advisedly the combined efficiency of the management and plant. Consider the case of a railroad. Its location, the manner of its construction, and the nature of its traffic fundamentally affect its cost of conducting operations. If its grades are low, its curvature slight, and its construction heavy, it can use heavy, powerful locomotives and haul long trains at a minimum of expense for fuel and labor. If its traffic is dense, it gets the reduced cost of doing business resulting from

a large volume and a full utilization of its capital investment. The percentage of grades and curvature, the weight of rail, and various other figures serve to indicate at how great an advantage or disadvantage the management operates due to the nature of the construction of its plant. The traffic density shows the advantage it has owing to the location of its plant, the territory the road runs through. The kinds of traffic carried show whether or not the management has the advantage of high-grade traffic paying the higher rates or must haul a heavy tonnage at small profits. All these things help to show the efficiency of the plant and do not go to credit of management except in so far as the management brought these conditions about. If the management can claim credit for the conditions, it must first discount the cost of bringing them about and deduct the capital charge before it can make a showing of business wisdom. No single figure expresses these advantages or disadvantages due to plant. These conditions can be taken into consideration only in a general way in checking up the percentage of earnings expended for the cost of conducting operations. If we make allowance for plant conditions, we can then take the percentage of earnings consumed in the cost of conducting operations as indicating

the efficiency of management. If it is low as compared with the average under similar conditions, we may draw the inference that the management displays a high degree of efficiency.

Cost of maintenance indicates whether or not the management is returning enough of the earnings to the property to maintain the efficiency of the plant. If it is not doing so, the operating ratio — that is, the percentage of earnings expended in operating expense — does not afford a proper index of the condition of the business. A showing of net earnings is being made essentially out of capital. During dull years corporations commonly do this, and even maintain dividends in this way. Paying dividends out of capital has to take some more obvious form in order to be considered reprehensible and to run counter to the legal prohibition. If a business, which is not essentially a “capital business” in its nature, makes a full allowance for maintenance, it is returning enough to the property to take care of depreciation. In the words a “capital business” we have coined an expression for our immediate purpose. By the term we mean some business in which the labor and other costs are not greatly significant in comparison with the capital cost. For example, the proprietorship and conduct of an apart-

ment house may well be regarded as a business. The cost of capital in such a business, if it be considered one, far outweighs other costs. If the business consisted of conducting a single apartment house, the management probably could not advantageously expend enough in maintenance to cover the full amount of depreciation. If the case were that of a large corporation owning and operating a considerable number of apartment houses, it might conceivably consider some new construction as essentially in the nature of maintenance, and amply provide for depreciation in that way out of earnings.

Directly opposite to an insufficient maintenance resulting in a showing of earnings not really made but amounting to an essential conversion of capital, the management may return to the plant more earnings than are necessary to keep the capital unimpaired. If earnings are diverted to capital by way of maintenance the management is developing a concealed asset which may be discoverable by analysis. Cost of proper maintenance comes much nearer to a standard than cost of operating, which depends directly on conditions of plant which cannot be standardized. The expense of maintenance depends directly on the cost of materials and of labor. These are the same for one enterprise as for another of the ✓

same kind. An examination of maintenance costs in a given business over a series of years indicates the amount a management must average to expend to keep the capital value of a property unimpaired. By comparing the proper average cost with the amount the management of a given enterprise actually expends for maintenance, a skillful analyst of accounts in the given business can make a pretty close estimate as to whether capital is just being maintained or is being encroached upon or added to through the operation of the maintenance account. It should be remarked that what is said of an excessive maintenance account does not apply to railroads since 1907. Since that date the accounting regulations of the Interstate Commerce Commission have stipulated against such practices. In that year expenditures for other purposes than strict maintenance were limited to \$200 for any one item. Since 1915 even the \$200 has not been allowed.

Especially in railroad enterprises, for which so much accounting information is available through the accounting requirements of the Interstate Commerce Commission, skillful analysts of railroad reports can draw many important inferences from an examination of the accounts besides the information the reports convey directly. With some knowledge

of the physical condition of the road derivable from various sources they can come to some pretty accurate conclusions about the operating skill of the management from an examination of the cost of operating account.

Of course the ability to draw the inferences from the accounting reports depends largely on the volume of material available for comparison. The most accurate and extensive reports of a single enterprise leave too much open to surmise. Variations in the cost of operating may indicate that the management is now more efficient or less efficient than formerly. They do not show at all that the best management the corporation has had may not be worse than a management of average efficiency. Variations in the cost of maintenance, unless over a very long term of years, with a full knowledge on the part of the analyst of variations in the cost of materials and labor over all those years, give no answer to the question as to whether the property is being over-maintained or under-maintained. For these purposes the analyst must have a fund of information gained from a knowledge of the business extensive enough to give him valuable averages for enterprises conducting that kind of business. Only the railroad business at present offers a sufficient fund of information to make analyses of this kind really

scientific. The various public utilities are just beginning to afford the basis of general information. For any kind of manufacturing enterprise conclusions are much more hazardous. In the railroad field, however, analysts of accounts have long made deductions from them that have gone much below the surface in arriving at opinions about the value of specific railroad securities.

The general form of income accounts presented so far serves substantially for a transportation or other public utility concern. With a manufacturing concern the cost of raw materials comes in to make such a fundamental difference in the nature of the business that expenditures cannot be accounted for in this manner and give anything like an adequate idea of the manner in which the business is being conducted. A form of income account which might be used would follow this outline: —

SHIPMENTS BILLED.

COST OF SHIPMENTS.

Cost of Materials.

Cost of Manufacturing and Selling.

Maintenance.

NET MANUFACTURING PROFITS.

OTHER INCOME.

TOTAL NET.

INTEREST.

SURPLUS FOR DIVIDENDS.

With this form giving the "Cost of Materials," the item "Cost of Manufacturing and Selling" gives a clue to efficiency of management and plant, and "Maintenance" gives a clue as to whether or not the capital of the corporation is being milked or fed through the maintenance account. What has been said on this matter applies as fully in principle to a manufacturing business as to any other.

One can hardly overstate how important it is that a corporation should show, as completely and accurately as possible within the reasonable limits of an annual report, a statement of its affairs so far as accounting science can show them. The precise form that the report should take is no part of our subject. That is the province of the expert accountant, and affords a sufficiently large world for his profession to conquer. But the capitalist who has presented for his investment the securities of a corporation, without being shown a reasonably full accounting statement of the affairs of the corporation, ought to refuse even to consider them. If he commits his capital to such an enterprise, he takes the position of a man who buys a pig in a poke, or purchases "sight unseen." If the corporation is a holding company, the investor is purchasing almost equally sight unseen unless he also sees rea-

sonably full information about the affairs of the subsidiaries. The discussion in the next chapter will develop the reason for this.

As the outline of the income account has indicated, the corporation may not distribute in the form of dividends all the profits which are stated to be "available for dividends." All the phrase means is that of the earnings stated for the period of the report the corporation has the legal right to distribute to shareholders that amount as profits of the business. Legal right and financial expediency ordinarily in this respect come to two very different results. It is generally desirable to adopt such dividend policy as to avoid, so far as possible, the necessity for reducing dividends during ordinary periods of depression. From the viewpoint of the corporation itself the investor occupies a much more important place in the financial scheme than the speculator. The investor seeks steadiness of income and commits his capital to such investments as seem likely to give it. He does not want merely an average of five per cent or six per cent over a period of years; he does want the actual five or six per cent every year. So the management of a corporation would ordinarily find it desirable to pitch its dividend policy at such a point that they feel confident they can maintain it.

The directors will, therefore, not declare as dividends the entire amount legally available for that purpose, but will set aside part of it to surplus account.

The amount so set aside does not, of course, ordinarily, except for accounting purposes, constitute a distinct fund. The directors simply invest those earnings back in the plant in extending or bettering it. Though accounted for in a separate account as surplus, they really make essentially an addition to the capital account. By reason of the extensions or betterments the corporation should increase its earnings. The surplus ought to be sufficient to enable the corporation in its dullest years to earn the amount required for its regular dividend rate. When the earnings, as a result of this policy of accumulation of surplus, reach a point where they can be relied upon to do more than this, then the directors can increase the dividend rate. If the directors are not certain that earnings have reached a point to justify an increase in the regular dividend and the surplus cannot be invested back in the plant to the best advantage, they may increase the distribution, but expressly announce the addition as a "special dividend" by way of giving warning that it is not to be relied upon as a regular disbursement of income. ▸

Just how much of earnings should be set aside as surplus for the sake of establishing the continuity of dividends presents a question requiring much wisdom in judgment. The general subject of corporation finance needs the results of much study on this problem. Only a few kinds of business yet afford even the materials for this study. Due to the requirements of the Interstate Commerce Commission the railroads have made public an abundance of material for that form of business. Various state public service commissions are bringing out enough material for the several kinds of public utilities. But for the various kinds of manufacturing business, not only is the material not available, but the problem is more difficult. In the public utilities field, however, this study is especially needed as part of the foundation for rate-making. Public service commissions purport to fix rates at a point that will allow a fair return on the capital. Earnings must be large enough to allow interest and dividend rates sufficient to attract new capital to the enterprise to provide the extensions and betterments demanded by a community growing either in size or in its demands for quality of service. As already stated, investors demand, or prefer, a steady income, and will advance funds on more advantageous terms on the

assurance of a steady income than on the fact of an equivalent average income. So, part of the problem of rate determination is what rate of steady income reasonably assured will prove sufficiently attractive to procure necessary new capital for the enterprise, and what amount of surplus set aside under circumstances of favorable earnings will give that reasonable assurance of continuity. Rates must be established at a point which will enable the payment of the required steady income and provide for a surplus fund which will in a degree guarantee the continuity of this income. That word "guarantee" indicates the essential nature of a surplus fund; it might with sufficient propriety be described as a "guaranty fund."

We have said that the directors invest the surplus back in the plant. In most cases they do. It may happen, however, that they cannot advantageously make this investment, or that they have special reasons for not doing so. Under such circumstances they may invest in special ways some or all of the earnings which form the "surplus after dividends," just as a sinking fund is invested. The corporation then has a distinct surplus fund which affords earnings from sources outside the regular business it carries on, and shows its guaranty nature more distinctly than an

investment back in the plant. Though created primarily for the purpose of assuring continuity of dividends, the surplus fund also goes to the building of a larger equity back of the bonds. The stockholder wants as much of the earnings available for dividends distributed to him as possible without interrupting the continuity of dividends, and always welcomes any increase in the disbursement. The bondholder always likes to see earnings go back into the plant.

The market places a value on the stock of a corporation on the basis both of the dividend payments and of the earnings available for dividends. Since a present income which may be immediately enjoyed is more valuable than a future income, the earnings not declared as dividends will not enhance the price of the stock nearly so much as those earnings which are immediately distributed to the stockholders. But the purchaser will estimate the value to him of the surplus earnings in so far as, in the first place, they give an assurance of the present rate of dividend disbursements continuing, and in the second place, in so far as they hold out a prospect of an increase in the dividend rate at some time in the future. The capitalist contemplating a purchase of the bonds of the corporation is interested in the amount of earnings left after operating

and taxes, and, therefore, available for the payment of interest. From his viewpoint the less of this paid out in dividends the better.

Directors are generally under no obligation to declare any dividends, no matter what the earnings are, and cannot be compelled to declare them unless the circumstances of their refusal have an element that is essentially fraudulent. If the stockholders differ from the directors on this matter of dividend policy, their remedy is to elect other directors as the terms of the present directors expire. A board of directors may declare a dividend whenever the affairs of the corporation show that it has a surplus, and up to the amount of the surplus. If the surplus has all been invested back in the plant, and the corporation has no cash to pay out in dividends, it may, unless there is a statute to the contrary, borrow money to procure the funds for the disbursement; or it may declare a stock dividend. As already described in the chapter on financing by an appeal to the stockholder, the sale of stock, with a market value at a premium, to stockholders at par, amounts essentially to the declaration of a special dividend. The declaration of a stock dividend comes to the same thing, except that the stockholders are not called upon to pay anything for the stock instead of making a payment less than the

market value. A stock dividend regularly has the nature of a special distribution rather than of the ordinary dividend payment. Though directors who have consistently turned earnings back into the property may sometimes declare a stock dividend just to give the stockholders something in the way of a dividend distribution and keep them satisfied with the management, usually a board of directors resorts to it for special purposes. It may be desirable to increase the number of shares so as to reduce the market price of the stock. Stock that sells close to par sells at an advantage over stock that sells at a high premium. Again, it may be that a close corporation has conducted the enterprise. The few stockholders have held the stock representing their interest in the business. No occasion has arisen for any trading in the stock, and the number of shares in relation to the value of the assets has not been material. But the owners of the business now wish to liquidate all or part of their interest by selling it to the general capitalist public. To do this successfully they need to have their stock have a market value at the maximum not greatly in excess of par. They may effect the result by declaring a stock dividend large enough to amount to a distribution of the surplus in that way. Such a procedure, how-

ever, is rather in the nature of a recapitalization than of a dividend.

Sometimes, instead of borrowing money to pay a dividend when the corporation has a surplus, which is entirely invested in the plant, the directors, wishing to maintain the appearance of regularity in dividend payment and anticipating a date when the corporate income will produce a cash surplus, may declare a dividend to be paid by the issuance of dividend warrants. These are simply in the general nature of notes of the corporation payable at a time when the directors anticipate that the corporation will be in funds. Such payments maintain the semblance of regularity of dividends and give the stockholder something on which he can actually raise cash and so really do give him the benefit of a continuity of income. The term "dividend warrant" used in the explanation of this transaction is sometimes used in another sense as simply indicating the checks (or it may be drafts) by which a corporation disburses a regular cash dividend.

CHAPTER VI

SPECIAL NATURE OF THE INCOME OF A HOLDING COMPANY

A PRESENTATION of the earnings of a holding company offers some special problems. The corporation may be entirely a holding company and not conduct any operations at all, or it may be partly a holding company and partly an operating company. Heretofore we have generally been viewing the earnings of a corporation as the result of directly conducting a business. For the most part, when discussing earnings, we have assumed simply that the earnings were those of an operating company. We can come to a true understanding of the income account and of the relationship of earnings to the various security issues of the plan of capitalization only by tracing them clear through from their origin as "income from operations." Each corporation intervening between "income from operations" and any part of income available for interest or for dividends creates a difficulty of analysis.

Securities of holding companies are sometimes presented to the capitalist with the statement that earnings available for interest

amount to so many times the amount required for that purpose, or that the earnings available for dividends amount to such a per cent on the stock. The presentation does not go back of the income of the holding company and may mislead those who are not familiar with the special nature of the earnings of a holding company and do not reflect on the situations that may arise through the intervention of an operating company. Another way in which those who are raising funds through the sale of securities of a holding company may mislead the unwary is by failing to protect the investor from the possibility of having new claims superior to his own created against earnings and assets.

Let us take a concrete situation to show the difference between the earnings of a holding company and those of an operating company. Assume a holding company — D — capitalized and earning as follows: —

<i>Holding Company D</i>	<i>Capitalization</i>
Bonds, 5 per cent.....	\$1,000,000
Stock.....	1,000,000
Net earnings.....	100,000

Obviously the statement can be made of the bonds of this corporation that the earnings available for interest are twice the amount required for that purpose. If the corporation were an operating company deriving its in-

come from rendering a public service, such a showing would indicate a minimum of risk in the bonds as an investment. Let us now make the further assumption that the holding company owns all the capital stock of three subsidiaries, Corporations A, B, and C, and that it has no other assets. Since the holding company owns all the stock of the subsidiaries, the number of shares of that stock does not matter; the holding company is entitled to all the dividends which the subsidiaries may declare.¹ So the only element of real concern to us at this point, in connection with the capitalization of the subsidiaries, is the amount of bonds they have.

Let us assume that the subsidiaries have bonds outstanding as follows: —

Bonds of subsidiaries

Corporation A, 5 per cent bonds.....	\$1,000,000
Corporation B, 5 per cent bonds.....	1,000,000
Corporation C, 5 per cent bonds.....	1,000,000

For our purpose here we do not need to set out the entire income account of each of these

¹ Since corporation statutes regularly require directors to be stockholders in the corporations in which they are directors, in actual practice a few shares would appear in the names of the directors. These are called "directors' qualifying shares." Even of these shares the directors may have the mere legal title. The holding company may have paid for them and have the entire equitable interest. For every practical purpose we may speak of the holding company as owning all the stock of the subsidiaries.

corporations. So, without presenting this, we will show simply the totals of the several items of the income account for all three, — that is, a consolidated income account. Let us assume, then, that the consolidated income account of these three subsidiaries makes this showing: —

Consolidated income account of subsidiaries

Gross earnings.....	\$500,000
Operating expense.....	250,000
Net earnings.....	250,000
Interest.....	150,000
Surplus available for dividends.....	100,000

To simplify the problem we can further assume that the management of the enterprise carried out by the holding company and these three subsidiaries has not adopted a policy of building up a surplus. Accordingly, let us have all this surplus available for dividends declared as dividends out of the treasury of the subsidiaries. The holding company, then, receives this \$100,000 into its treasury. We can neglect the expenses of the holding company, which, since it does not conduct any operations, would be merely nominal, a matter of keeping a not very extensive set of books, and assume that this entire \$100,000 becomes net earnings of the holding company. Looking back to the statement of net earnings of the holding company one will see that we have assumed this as the situation.

Suppose now that a period of business depression sets in and causes a decline of 10 per cent in gross earnings. Assume, too, that the management cannot keep maintenance up and at the same time effect a reduction in the cost of operating. This might very well be essentially the case. Since we will make the same assumption in the set of figures we will adopt for comparison to bring out the situation, it does not, anyway, affect the soundness of our argument. On this decline of 10 per cent in gross we have, therefore, this showing for the consolidated income account of the subsidiaries: —

Income account after gross has declined ten per cent

Gross income.....	\$450,000
Operating expense.....	250,000
Net income.....	200,000
Interest.....	150,000
Surplus available for dividends.....	50,000

Owing to the inflexible nature of the interest charge a decline of 10 per cent in gross earnings has cut the surplus available for dividends in two. Then with respect to the holding company we have this showing: —

Net earnings of Holding Company D...	\$50,000
Interest charge of Company D	50,000

A decline of 10 per cent in the gross earnings of the subsidiaries has entirely wiped out the margin of safety for the bonds of the hold-

ing company, which, before the period of business depression, had earnings available for interest of twice the amount required.

Compare this situation with what the situation would be if D were an operating company able to show net earnings of twice the interest charge, with all the conditions of operating the same as for the subsidiary operating companies just set forth. We will assume then that an operating company shows net earnings of \$100,000. Working under the same conditions with an operating ratio of 50 per cent, the cost of operating then would be \$100,000, and we have as an income account for our Corporation D as an operating company: —

Income account of Corporation D as an operating company

Gross earnings	\$200,000
Operating expense	100,000
Net earnings	100,000
Interest	50,000

That is, we have just the same relationship between net earnings and interest charge as before when our Corporation D was a holding company. Earnings available for interest are twice the amount required for that purpose. Now, let us again assume a decline of 10 per cent in gross earnings during a period of business depression, and we find our income account of corporation D as an operating company makes the following showing: —

Income account of Corporation D as an operating company after gross has declined ten per cent

Gross earnings.....	\$180,000
Operating expense.....	100,000
Net earnings.....	80,000
Interest charge.....	50,000

When D was a holding company we found that, under the conditions stated as to the subsidiaries, a decline of 10 per cent in gross earnings of the subsidiaries reduced the earnings of D available for interest from twice the amount required right down to an amount leaving not a dollar in excess of the interest charge. With D as an operating company making earnings available for interest of twice the amount required, then suffering a decline of 10 per cent in gross, we have a margin of safety of earnings available for interest of 60 per cent in excess of the amount required. We have kept the same conditions in the cases compared. In both cases we assumed that the corporation would not be able to reduce operating at all on the decline of gross. The results would not have been different essentially if we had made some reduction in the operating cost in both cases. Our only reason for not doing so has been to keep the problem as simple as possible.

✓ This discussion has traced through the argument to show the difference there may be between the earnings of a holding company

and those of an operating company due to possible existing fixed charges of the subsidiaries in the case of the holding company. We will go on with the discussion to show the possibility, unless guarded against, of increasing the fixed charges of the subsidiaries, and the effect of such an increase on the safety of the bonds of the holding company.

Let us assume an existing situation of the holding company as before: —

Capitalization holding Corporation D

Bonds 5 per cent.	\$1,000,000
Stock.	1,000,000

Debt of subsidiaries

Corporation A has	\$1,000,000 5 per cent bonds
Corporation B has	1,000,000 5 per cent bonds
Corporation C has	1,000,000 5 per cent bonds

For the purposes of this discussion we must make an assumption as to the actual total investment in the enterprise as a whole carried on by these three operating companies and the holding company. Let us assume, then, that the enterprise represents a total capital investment of \$4,000,000. If distributed equally among the operating companies this would give an equity in each of \$333,333.33 above the par of the bond issue. Then assuming a gross income of the subsidiaries of \$500,000, and the same operating conditions as before, we have: —

Consolidated income of subsidiaries

Gross earnings.....	\$500,000
Operating expenses.....	250,000
Net earnings.....	250,000

With net earnings, then, of \$250,000 on a commitment of \$4,000,000 of capital to the enterprise, it appears that the business earns 6.25 per cent on the actual investment. Now, let us assume that for some reason the management of the enterprise wishes to extend the plant, and has Corporations A and B each issue an additional \$1,000,000 of bonds, which are disposed of at 80, and use the proceeds in plant extension. This makes an additional investment in plant of \$1,600,000. We will assume that the business earns the same rate of return on this additional investment as on the capital originally committed, or 6.25 per cent. Then net increases by just \$100,000. Let the operating ratio remain at 50 per cent. Since net was \$250,000 before, it is now \$350,000. With an operating ratio of 50 per cent, the operating expenses will, of course, be \$350,000, and the gross \$700,000. Stating this in tabulated form and we have:

New income account

Gross earnings	\$700,000
Operating expense.....	350,000
Net earnings.....	350,000
Interest charge (increased on account of the \$2,000,000 new bonds)	250,000
Surplus available for dividends.....	100,000

On the showing we have made we have increased the debt of the subsidiaries, but have not caused any increase in the earnings of the holding company. Now, assume that gross earnings decline 10 per cent and we have this showing (assume that the operating cost is not reduced):—

New income account on decline of ten per cent in gross

Gross earnings.....	\$630,000
Operating expense.....	350,000
Net earnings.....	280,000
Interest.....	250,000
Surplus available for dividends.....	30,000

That is, we have available for dividends on the consolidated earnings of the subsidiaries, or as the net income of our holding company, the sum of \$30,000. But the holding company has an interest charge of \$50,000. Before the increase in the debt of the subsidiaries a decline of 10 per cent in gross reduced the earnings of the holding company available for interest from twice the amount required for that purpose down to an amount which left no surplus. Since the increase in the debt a corresponding reduction in gross of the subsidiaries would reduce the earnings of the holding company available for interest down to only 60 per cent of the sum required.

Of course this possibility of increasing the debt of the subsidiaries can be guarded

against, and the investor who is not willing to take this chance should be sure that it is guarded against. To safeguard the situation the stock of the subsidiaries should be deposited as collateral security for the bonds of the holding company. Though the directors of the holding company should be left free to vote the stock except in the event of default, the trust deed under which the stock is deposited should contain a covenant that the subsidiaries shall not incur any additional debt. The entire discussion in this chapter has obviously assumed that the bonds of the subsidiaries are outstanding in the hands of investors, and therefore exist as a claim against the earnings of the subsidiaries which must be satisfied before the holding company can get any revenue from the earnings.

Examples presented to illustrate the principles involved have been those of a corporation which is entirely a holding company; that is, one not doing any operating directly at all. Such examples were chosen for the sake of simplicity. If a corporation is partly an operating company and partly a holding company, the same situations may arise with respect to that part of the earnings which are derived as a result of the operations of the subsidiaries. And if the corporation which is offering securities for sale does not own all of

the stock of another corporation, but only a majority, or an amount sufficient to control, or even any amount of stock less than that, the same principles apply so far as the earnings derived as a result of the ownership of that stock are concerned. If the corporation owns less than a controlling interest in the stock of another corporation, one considering the securities of the holding company will ordinarily regard the stock owned as simply in the nature of an investment, and place a value on it as such.

In the chapter in the first volume on "Financing an Expansion" we discussed the creation of subsidiaries as a device to enable the giving of a first mortgage or other direct lien on specific assets when the existence of a blanket mortgage created by the existing corporation would prevent the creation of any claim ahead of or equal to it if the corporation should own the specific assets directly. The relationship of a holding company and a subsidiary may arise when one corporation desires to have an interest in another, but cannot advantageously buy all of the stock, or a sufficient amount to effect a merger. Or, if it can buy all of the stock, legal reasons — as the necessity of a public service corporation operating in a given State having a charter from that State — may make it necessary

or expedient to maintain separate corporations.

Legal reasons for the desirability of maintaining separate corporate entities, the advantage of financing with the large issues of the securities of a holding company rather than with the relatively small issues of the directly operating units, and the better organization possible if the directly operating units are bound together by a holding company, make very real advantages which have fostered the growth of holding companies especially in the public service field. Our discussion has several times indicated the advantage of the large issue in the possibility of making the security known and creating an active market. This chapter has simply pointed out the need for full information.

CHAPTER VII

ORIGIN OF THE COMPLEXITY OF LIENS

IN the case of railway bonds the reader of financial advertisements and circulars, who is not entirely familiar with the processes of corporation financing, may not readily understand how it comes about that a bond may be secured by a first mortgage on part of a railroad system and have a second mortgage or other junior lien on other parts of the system. Though the chapter in the first volume on "Financing an Expansion" contains the clue to the situation, it seems desirable to extend the explanation by presenting a concrete illustration of the building up of an assumed simple railway system showing the result in diversified liens.

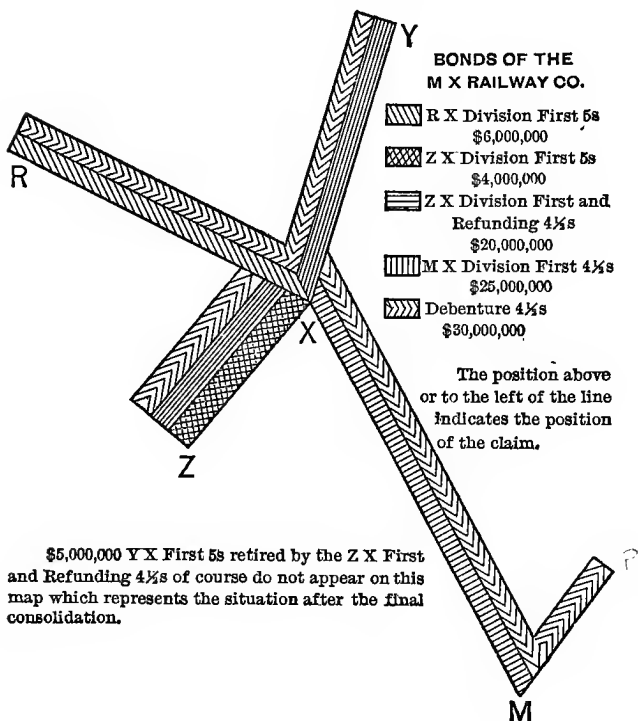
Let us assume that at about the same time one group of men formed a corporation to build a line of railroad from X to Y, and another group of men formed another corporation to build a line from X to R. One corporation, the X. Y. Railroad Company, financed its construction by an issue of \$5,000,000 X. Y. 20 year first mortgage 5's and \$7,500,000 of common stock, and the other corporation, the X. R. Railroad Company

similarly financed its construction by issuing \$6,000,000 X. R. first mortgage 5's and \$6,000,000 of common stock. Our earlier railroad mileage was built in just that way by different groups, in what would now seem small sections. No group had developed financial power enough to build or own a line from the Atlantic to Chicago.

The group in control of the X. Y. Railroad Company, we will suppose, now sees the desirability of having a line from X. to Z. The mortgage securing the X. Y. first mortgage 5's is a blanket mortgage, and the group in control of X. Y. wants to be able to offer a first mortgage on the new mileage in order to finance it. So they incorporate the X. Z. Railroad Company and have the new corporation proceed to authorize \$4,000,000 X. Z. first mortgage 5's. The X. Y. Railroad Company owns all the \$5,000,000 of stock of the X. Z. Railroad Company.

Since the lien of the X. Z. first mortgage 5's has attached to the property, the management of the X. Y. Railroad Company, as soon as the construction of the X. Z. is completed, vote the stock of the X. Z. Railroad Company for a physical merger of the X. Z. property to make it an integral and directly owned part of the X. Y. property. The X. Y. Railroad Company is now taking all the assets of the

X. Z. corporation and dissolving the corporation; it will, therefore, assume the bonds of the X. Z. corporation, — that is, become the



general obligor on and place its general credit back of the X. Z. first mortgage 5's, which, of course, continue to have their first mortgage lien on the line of railroad running from X. to Z. The X. Z. first mortgage 5's then

become the X. Y. Railroad Company X. Z. Division first mortgage 5's. Since the mortgage securing the X. Y. Railroad Company first mortgage 5's is a blanket mortgage, stipulating that the lien of the mortgage shall extend to all future acquired property of the X. Y. corporation, now that the X. Y. Railroad Company has acquired the property of the X. Z. Railroad Company, the lien of the X. Y. first mortgage 5's will extend over the X. Z. line. The X. Y. Railroad Company, however, has acquired the X. Z. line subject to the existing first mortgage, and therefore has bought, to speak in legal terms, the equity of redemption in the property. So the lien of the X. Y. first mortgage 5's is a mortgage on this equity of redemption, or, as we say, a second mortgage on that part of the property of the X. Y. Railroad Company which forms the X. Z. Division.

While all this has been going on, let us assume that another group of promoters in the city of M. has been projecting and building a line of railroad from M. to X. This is a much larger undertaking than any of those we have been considering. Its projectors capitalize the M. X. Railroad Company at \$25,000,000 first mortgage $4\frac{1}{2}$'s, \$15,000,000 6 per cent preferred stock and \$25,000,000 of common stock. The M. X. Railroad Com-

pany proves a profitable enterprise and increases in financial strength.

Meantime the X. Y. Railroad Company has prospered and its management has seen certain advantages that would result if it could add the X. R. Railroad Company to its property. It buys up quietly a good deal of the stock of the X. R. Railroad Company and makes an offer to the remaining stockholders which results in its acquiring enough of the stock to control the situation. Let us assume that, under the laws of the jurisdiction in which the X. R. Railroad Company is incorporated, a vote of seventy-five per cent of the stock of a corporation is sufficient to authorize a sale of the assets of the corporation. Of course, the sale must be at such a price as will afford the minority of stockholders a proper compensation. A majority sufficient to vote a sale of the assets must not exercise their power in such a way as to work a fraud on the minority holders. It would not be necessary for the X. Y. Railroad Company actually to acquire three quarters of the stock of the X. R. Railroad Company. If by means of a depository committee, or otherwise, they can count on a three-quarters vote to approve the proposal, they can go ahead. It may be that the management of the X. Y. Railroad Company does not want the stock of the

X. R. Company unless it can get enough to put through the merger. In that event, it will prefer not to begin buying the stock, since it may not be able to acquire enough on sufficiently advantageous terms. It can organize a depository committee of stockholders of the X. R. Railroad Company and agree to pay a stated amount for the X. R. property provided it gets enough assenting stockholders to put through the transaction. Then, if it fails to gain the adhesion of enough of the stockholders of the X. R. Company the depository committee can simply return the certificates to the stockholders, and the X. Y. Railroad Company is not possessed of any stock it does not want.

The management of the X. Y. Railroad Company, then, votes to acquire the X. R. property on certain terms, and the stockholders of the X. R. Railroad Company vote to accept those terms. We will assume that any minority stockholders of the X. R. Railroad Company are nearly enough satisfied with the transaction not to oppose it, and the transfer takes place. In view of the enlarged scope of their activities the management of the X. Y. Railroad Company has the name of the corporation changed to the X.Y. & R. Z. Railroad Company.

How did the old X. Y. Railroad Company

provide the funds to acquire the new X. R. property? Let us assume that at this time the X. Y. first mortgage 20 year 5's were closely approaching maturity. Then the X. Y. Railroad Company authorized a first and refunding mortgage bond issue. It authorized bonds to be issued under this mortgage of \$20,000,000. Of this amount the mortgage provides that \$5,000,000 are to be issued immediately to provide funds to meet the maturity of the X. Y. first mortgage 5's. The mortgage reserves \$4,000,000 to provide for the retirement of the X. Z. Division first mortgage 5's when they mature. It authorized the issuance of the remaining \$11,000,000 from time to time to provide funds for new construction or the purchase of additional property or the purchase of the securities of other railroads. Since the X. Y. Railroad Company has now had a long record of good earnings it can borrow money on more advantageous terms than it could while in the process of construction. We will assume that it makes these new bonds $4\frac{1}{2}$'s and has them run for a term of fifty years. It carries out the refunding operation and retires the \$5,000,000 first mortgage 5's. The X. Y. Railroad Company then buys stock of the X. R. Railroad Company, from time to time borrows funds at the banks temporarily to make

immediate payments, and, as it acquires the stock, issues additional $4\frac{1}{2}$'s to pay off the bank loans. We will assume, as would ordinarily be the case, that the new $4\frac{1}{2}$'s first and refunding mortgage is a blanket mortgage. Then after the X. Y. Railroad Company had carried out the merger of the X. R. line with its existing properties and had become the X. Y. & R. Z. Railroad Company, these new first and refunding $4\frac{1}{2}$'s have a first mortgage on the line from X. to Y. (the previously existing first mortgage has been retired), a second mortgage on the line from X. to Z., — that is, subject to the X. Z. Division first mortgage 5's, — and a second mortgage on the newly acquired line from X. to Z., — that is, subject to the existing X. Z. first mortgage 5's. Of course the X. Y. & R. Z. Railroad Company assumes payment of the X. Z. first mortgage 5's and they become X. Y. & R. Z. Railroad Company X. Z. Division first mortgage 5's.

Meanwhile, the affairs of the M. X. Railroad Company continue to prosper. Its management becomes impressed with the advantages of bringing the M. X. and the X. Y. & R. Z. together in a single system. Just as the X. Y. had done in the case of the X. R., now the M. X. proceeds to acquire stock of the X. Y. & R. Z. To finance these purchases the M. X.

provides a collateral trust issue, the M. X. Railroad, X. Y. & R. Z. collateral trust $4\frac{1}{2}$'s, of which it authorizes \$20,000,000. Let us assume that by means of this issue the M. X. Railroad Company acquires practically all of the stock of the X. Y. & R. Z. So the management of the M. X. creates an extensive railroad system, and for some time operates it in this form. Let us assume that the management comes to see an advantage in unifying the system into the ownership of a single corporation. It must get the consent of its X. Y. & R. Z. collateral 5 per cent bondholders. Their security is the stock, and in effecting a merger the stock will no longer exist. So the management of the M. X. Railroad Company offers these collateral bondholders a new security. To make the problem simple, let us assume that the collateral trust $4\frac{1}{2}$'s have a market value of just par. At the same time the management of the M. X. Railroad Company wants to provide funds for an extension from M. to P. that will cost about \$5,000,000.

The management of the M. X. Railroad Company organizes the M. P. corporation, and constructs the line from M. to P. The M. P. corporation authorizes \$5,000,000 of first mortgage 5 per cent bonds. The management of the M. X. Railroad Company

then organizes a new corporation, the M. X. Railway Company, with the same amount of stock as the M. X. Railroad Company and proceeds to authorize \$30,000,000 of debenture $4\frac{1}{2}$'s and to make terms to have the M. X. Railway Company take over all the properties of the M. X. Railroad Company. Holders of stock in the M. X. Railroad Company are willing to take the stock of the M. X. Railway Company share for share, provided that it owns all the properties which they now own. In the trust deed securing the debentures the railway company agreed not to create any new lien that would come ahead of the debentures, and if it should create any new mortgage at all, that it would secure the debentures equally with any bonds issued under the mortgage. Of the \$30,000,000 authorized, \$5,000,000 could be issued only on the deposit under the trust deed of the \$5,000,000 first mortgage 5's authorized by the M. P. Railroad Company.

Holders of the M. X. Railroad Company X. Y. & R. Z. collateral trust $4\frac{1}{2}$'s are willing to accept these new debentures in place of their collateral trust securities. The new debentures give the same income return. Though the new issue is larger than the old, it is given a stronger position in that no mortgage can be placed ahead of it. This improved position

extends to the line of the M. X. To offset part of the larger amount of debentures there is the additional security of the line of the M. P. on which the debentures have virtually a first mortgage claim through the deposit of the first mortgage security of the M. P. Railroad Company. For the other \$5,000,000 additional of the debenture issue the trust deed provides that they may be issued only on evidence to the trustee of additions to the capital account of the railroad for a like amount. So, all things considered, the holders of the collateral bonds are willing to accept the new security in place of the old, and the exchange is made. Of course, on the transfer of the property the new corporation assumed all the outstanding bonds of the old corporation.

(*Note*) The White and Kemble maps show the various liens of bond issues on the railroad systems of the United States.

CHAPTER VIII

REORGANIZATIONS

So far our discussion has considered only those changes in the capitalization of corporations which result from the ordinary conduct of their affairs. We have contemplated the original issuance of securities at the time of organization and such additions as may be made from time to time to supply the funds for increases in the capital account required by an expansion of the business. We have also considered such changes as may result through the redemption of outstanding securities, either for sinking-fund purposes, or to allow their replacement by a larger issue with the same lien, or to absorb a surplus for which the corporation has no other immediate use. We have indicated the change which may result from the issuance of a convertible security through the conversion of part or all of an issue of bonds into stock or through the conversion of part or all of an issue of preferred stock into common stock. All such changes in the capitalization of a corporation come about in the ordinary course of the financial management of the business. We

have still to consider extraordinary changes which may take place in the financial plan of an enterprise.

Such extraordinary changes may come about as a result of insolvency or may take place without insolvency. They may be made to remedy some existing defect in the financial structure or to meet some new and unforeseen requirement of the business. If they are made as a result of insolvency, they may accompany foreclosure proceedings or be accomplished without foreclosure. When they accompany foreclosure we say the corporation has gone through a "reorganization." If the change in the plan of capitalization takes place as a result of insolvency without foreclosure, we may say that the corporation has undergone a "readjustment of the capital account." In the event that it has become desirable to make a rearrangement of the corporation's finances, although it continues as an entirely solvent or, indeed, it may be, an exceptionally prosperous concern, — in that event we will speak of the rearrangement of finances as a "recapitalization."

Let us first take up a matter of reorganization. We will assume a railroad corporation, the X. Y. Railroad Company, capitalized as follows: —

Various issues of divisional bonds aggregating	\$10,000,000
First and refunding mortgage 4½ per cent bonds	25,000,000
M. X. Railroad Branch Line collateral trust 5's	5,000,000
General mortgage 5 per cent bonds ..	20,000,000
Preferred stock, 6 per cent cumulative	10,000,000
Common stock	25,000,000

We will assume that the corporation has committed some default in its obligations to its general mortgage bondholders which entitles them to foreclose on the property under their mortgage. The bankers who financed the corporation may stipulate, and the corporation may agree, that breaches of various agreements on the part of the corporation shall constitute defaults entitling the bondholders to foreclose under their mortgage. Of course, the default regularly leading to foreclosure is a failure to pay either principal or interest when it falls due. The mortgage regularly stipulates that a failure to pay interest shall make the principal due and payable.

We will assume, then, that the management of our corporation foresees that it will not be able to pay the interest falling due on its 5 per cent general mortgage bonds at the next interest period. The earnings of the corporation are sufficient to continue the payment of interest on the first and refunding

4½'s and on the underlying divisional bonds. We have to consider the \$5,000,000 of collateral bonds secured by the deposit of all the stock and bonds of a branch line. The earnings of the branch line have fallen to a point where the net is not sufficient to meet the interest charge on account of the collateral bonds secured by the deposit of the branch line securities. So far as the claim of these collateral bonds against the issuing corporation is concerned, they are, of course, a general obligation merely and junior to the general mortgage 5's. The interest date on these bonds is, let us say, a month later than that of the general mortgage 5's, and the failure to pay this interest when it falls due will naturally follow the failure to meet the interest charge of the general mortgage issue.

Directors and officers of the corporation consult with the bankers who have done its financing and they decide to be ready to apply for a receivership. That the receivership should be foreseen and planned for under such guidance is usually in the best interests of all the people who have any concern about the property. Such managers of affairs are best equipped to proceed along a well-defined line of action and to harmonize the conflicting interests. We will refer to them as "the management." If the various inter-

ests should be permitted to proceed at haphazard, they would cause a much greater delay in reaching a settlement and largely increase the total losses. Usually it is desirable that the receiver be appointed by a federal court. It is especially important that the federal court should assume control of the property if it is a line of railroad running through or into more than one State. For the purpose of getting a federal receivership counsel for the management, looking forward to the anticipated default, will prepare a creditors' bill in which bondholders or other creditors, living in some State other than the State in which the corporation is incorporated will appear as the petitioners for the receivership. The fact that the petitioners are citizens of a different State from that in which the corporation is incorporated gives the necessary diversity of citizenship to enable the federal court to take jurisdiction and appoint a receiver.

If a state court appoints a receiver, the receiver can take only the property in the jurisdiction of the court. The court has no jurisdiction outside of its own State and for property of the corporation in another State another appointment of a receiver will have to be made. Even if no quarrel arises among different sets of creditors and even if the

courts of other States would appoint the same man appointed by the court of first jurisdiction, the delay in the appointment and his responsibility to the several courts would cause expensive and otherwise serious difficulties and delays.

The mere fact of a default in the payment of interest will not in itself give the court a sufficient ground for the appointment. The court must be shown that a receivership is necessary to prevent loss or injury to those financially interested. If there is a default, however, sufficient other grounds can usually be found to justify the appointment.

When the receiver is appointed, the management of the property owned by the corporation is taken out of the hands of the officers of the corporation and vested in the court appointing the receiver. He is simply the officer or agent of the court. On all large matters of policy and on any question outside of the ordinary matters of operation he must go back to the court for authority.

The appointment of a receiver does not change the nature of the legal rights of the security-holders. He acts, however, as an agent of the court exercising its equity jurisdiction. While the property is in the possession of the court acting as a court of equity, legal rights may not be enforced except with

the permission of the court. The principle underlying this suspension of the legal rights of the security-holders is that the prompt enforcement of the legal rights of any one set of security-holders or other creditors might work such an injury to other people who have a financial interest in the property as to amount to an essential injustice. The law says in substance to the defaulted bondholder that the damage he may do another by a prompt enforcement of his right will be so much greater than the damage he will suffer by delay that the real justice of the situation demands that he suffer the delay.

It is the duty of the receiver immediately on his appointment to take possession of all the property covered by the mortgage securing the bondholders, or subject to the satisfaction of the demands of the creditors, who made the application for his appointment. The corporation no longer has any voice in the management of the property. The receiver operates the road with essentially all the powers that the corporation had before his appointment. The directors of the corporation, however, necessarily looked at every question from the viewpoint of the interest of the stockholders. The receiver must pursue such a course as will best conserve the property for the benefit of all people finan-

cially interested. Whenever extraordinary matters come up, or he is in doubt about what course he ought to pursue, he should consult the court.

The receiver may do some things which have an important bearing on the financial position of the business. If any part of the property which comes into his possession consists of leased property and he considers the terms of the lease not advantageous to the business, he may elect to disaffirm the lease: that is, he may discontinue operating the leased property and turn it back to the lessors. He is not obliged to do this at once, but may take possession of the leased property and operate it long enough to learn whether it is profitable or not.

He may find, among other property that has come into his possession, certain cars and locomotives which the corporation had bought under the terms of an equipment trust agreement. Just as in the case of the leased line the receiver may elect to disregard this agreement. He may then turn the equipment back to the equipment bondholders. If the receiver finds the equipment necessary to run the business properly, he may retain it for his use, and he will, in that event, be obliged to pay whatever the use is reasonably worth. The retention of the equipment, though the

receiver may refuse to recognize the terms on which it was bought, is justified on the ground that the railroad is a public service corporation, — that is, a business affected with a special public interest, — and the importance of continuing to render the service to the public overrides other considerations. This general principle pervades the management of a railroad property in the hands of a receiver.

The most usual demand made on the receiver for new financing arises out of the general physical condition of the property. Ordinarily this is seriously depleted by the time it comes into the receiver's possession. The management of a corporation naturally pays interest at the expense of maintenance just as long as it can, until it is confronted with the fact that the cost of conducting operations has increased because of the bad condition of the property. The property may have reached such a state of deterioration that it would be impossible to continue operations, no matter how great the cost, without first spending substantial sums on maintenance. If the receiver is to operate the property, he must raise the funds to meet these necessary expenditures.

This brings up the problem of financing a business in a receivership. Since the business

is in such a condition that it cannot meet its obligations to its existing creditors, obviously no one will advance funds to the business without some special assurance of payment. To meet the situation the law must allow any one who supplies new funds a preferred position. To provide the funds the court authorizes the receiver to issue receiver's certificates, and in its order gives them such priority as it considers necessary. It may, and usually does, give them a lien on the assets and earnings of the business ahead of every other lien on the property except for taxes. The order of the court may, however, place the lien anywhere, and might place it only just ahead of that of the bonds in default. The court also determines the rate of interest the certificates may bear and the price at which they may be sold. If they should fall due before the receivership is terminated, they would ordinarily have to be refunded by another issue of certificates. Those outstanding at the time of the adoption of a plan of reorganization have to be provided for in the plan. Bondholders are entitled to notice of the application for the issuance of receiver's certificates and to appear in court and show that they are not necessary, or that it is not necessary to give them a lien ahead of the bonds.

Let us assume that in the case of the X. Y. Railway Company the general mortgage bondholders make application for the issuance of \$500,000 of receiver's certificates to put the property in condition, and that after a hearing the court grants the application and orders that they bear interest at the rate of 6 per cent and fall due in three years. The court authorizes the receiver to sell them at 98½.

In discussing the receivership we have run a little ahead of the story. At the same time that the creditor's bill making the application for the receivership was being prepared the management was also forming a bondholders' protective committee. To do this, they get four or five men whose names are likely to be favorably known to the bondholders to serve on a committee to take care of the interests of the bondholders during the receivership. The committee, it is anticipated, will also follow up the rights of the bondholders through the foreclosure. Presumably they will supervise the work of drawing up the plan of reorganization. It is desirable from the standpoint of the management to have the personnel of this committee all determined and ready to announce as soon as the application for the receivership is made. The prompt announcement of a pro-

protective committee may forestall the appearance of another committee. For the formation of a protective committee is purely a volunteer matter. Any group of men may announce themselves as a protective committee for any of the issues of securities and ask holders of the issue to place their interests in its hands. If the management does not have a committee ready to be announced, other volunteers are sure to appear. Though the management does form a committee which announces itself promptly, it is still possible that other committees will appear. Even in that case the committee arranged by the management gains strength from the very fact of being the first. It stands in the position of being the "official" committee. Later committees must assume the position of being in opposition. Of course the management hopes that if its committee is early in the field these opposition committees will not appear. No security-holder can be compelled to entrust his interests to any committee. But the influence of any committee depends on how large a proportion in holdings of owners of the issue it can win the adherence of. As one device for getting bonds deposited, the committee may offer to pay depositors the interest installment immediately in default and take the deposited bonds as collateral for the

advance. The present cash, the immediate continuance of income, may loom rather large in the eyes of the bondholder, and, seeing no special reason why he should not deposit, it may induce him to act. The mortgage securing the bonds may give to the holders of a majority of the bonds, or to the holders of seventy-five or of eighty-five per cent, certain powers, so that the action of the specified proportion will be binding on the rest. If such provisions are in the mortgage they form part of the contract with all bondholders, and the minority have no legal right to complain if the specified majority exercise the authority the mortgage gives them. If the committee can get the required majority to entrust their affairs to it, then it can take advantage of such powers as the required majority may have. Quite apart from these special provisions the weight of the committee in the proceedings looking toward reorganization will depend upon the number of security-holders it represents. Of course, in saying "number of security-holders" we mean the holders of a given number of bonds; that is, it is the number of securities held rather than the number of people holding them that counts. Besides, there is a wide difference between not representing all the security-holders and having those security-holders who have not chosen

the "official" committee to represent them represented by another committee.

While getting ready with the committee to solicit the support of the holders of the most important defaulting bond issue, the management will at the same time endeavor to have a harmonious personnel on the committees to represent the holders of other issues of securities. There will be a committee for every issue of bonds, debentures, or notes in default, and for each stock issue. Some of the issues which are not in default, and in which defaults are not anticipated, also may have protective committees. This may prove advisable because matters may come before the court in the receivership, particularly the question of placing the lien of receiver's certificates ahead of the lien of bonds not in default, which will affect their interests, and in which they will need to be heard. Of course, the holders of all securities prior to those in default have a lively interest in the processes of the receivership and the reorganization, and may need constant representation to see that their interests are protected. Though the interests of the holders of the various security issues are necessarily divergent, there is a great difference between having protective committees which will work together as harmoniously as their divergent

interests will permit, and having committees which will clash more than their jeopardized interests make inevitable. So it will be part of the problem of the management endeavoring to shape the general course of the reorganization to have as attractive a personnel as possible appear to solicit the representation of holders of the various other issues of securities as well as of the holders of the principal issue in default.

Leaving for the moment the consideration of these various other committees, let us trace through the procedure of the principal committee; that is, the one to represent the holders of the principal issue in default. The bondholders will signify their consent that the committee shall represent them according to the terms of the protective committee's agreement by depositing their bonds with some trust company designated as depository and accepting a depository receipt or certificate for them.

It is important from the viewpoint of those expecting to guide the reorganization that this protective committee's depository agreement should give the committee broad powers. Such broad powers are probably in the interest of the depositing bondholders. To act effectively the committee needs authority to meet emergencies and to choose its

policy from the widest possible field. This depository agreement looks forward to a plan of reorganization. The committee must get the special consent of a depositing bondholder to the plan of reorganization, or permit him to withdraw his bonds so that he will not become a bondholder assenting to the reorganization plan, and the protective committee's depository agreement will provide for such withdrawal. Showing how the protective committee's agreement anticipates the preparation of the plan of reorganization, read the following quotations from one such agreement: —

The committee shall have power, if and whenever it deems such action advisable, to prepare and adopt a plan for the reorganization or readjustment of the railroad company, its affairs and properties, including or excluding, as the committee shall determine, the affairs and properties of any one or more of the railroad company's subsidiary, controlled, affiliated, or allied companies or interests, or may approve and adopt any plan for the reorganization or readjustment thereof, though not prepared by it. Such plan may provide for the reorganization of the company or the adjustment of its affairs either alone or in conjunction with the reorganization of or adjustment of the affairs of any other corporation or corporations which, in the opinion of the committee, it is desirable should be included in such

plan, and for the acquisition of any property deemed desirable for the purposes of such reorganization or readjustment, and may provide for vesting in a single corporation, or in one or more corporations, whether the present railroad company or some other corporation or corporations, all or any of the properties of the railroad company and other properties and for the sale, lease or other disposition of any properties of the railroad company or other properties. Any such plan may recognize and make provision for any or all of the securities, obligations, and indebtedness of the railroad company and of any other corporation or corporations included in said plan, whatever may be their priority of lien, and also for any or all liens upon the properties of the railroad company or of such other corporation or corporations, or upon any other property acquired for the purposes of reorganization, and prescribe the respective terms and conditions on which the holders of each or either of the classes of stock or certificates deposited hereunder, or of others of the securities, obligations, indebtedness or liens aforesaid, may obtain such recognition and participate in the benefits of the plan. Any such plan of reorganization or readjustment may be prepared or approved, and adopted by the committee, either before or after a sale, or a contract for the sale, of the franchises, properties, or assets of the railroad company or any part thereof, or of any subsidiary or allied corporation. Such plan may provide for the sale or exchange of the shares of stock or stock trust certificates deposited hereunder or either class thereof (preferred or

common) or any of them, or for the sale or resale of any property or any part thereof acquired by or on behalf of the committee hereunder, and may contain all such provisions as the committee shall deem advisable for the reorganization of the company or the readjustment of its affairs either alone or in conjunction with the reorganization of any other corporation or corporations, and for raising or obtaining all funds deemed necessary for the purposes of such reorganization or adjustment.

Such plan may constitute managers of the reorganization or readjustment under it and provide for their compensation and expenses and the members of the committee, or any of them or the members of any other committee of the holders of the stocks, bonds, obligations, or liabilities of the railroad company, or representative of such stocks or of the stocks or securities of any other corporation or corporations, may act as such managers or may be members of any committee constituted by said plan.

Such plan may make provision for the payment of the compensation, disbursements and expenses of the committee and of any other committee or committees representing the holders of stock, bonds, obligations or indebtedness of the company or of any other corporation or corporations, or of certificates representative thereof, and may charge with the payment thereof or of any part thereof, as well as of all or any part of the indebtedness, liabilities, and obligations incurred by the committee and any such other committee or committees, the shares of stock, bonds,

obligations, securities and property or any part thereof at any time subject to such plan; and may confer upon the committee or any other committee or committees constituted thereby or provided for therein or upon the managers thereunder, any powers and discretion which the committee, in its uncontrolled discretion, may deem proper and expedient, although not expressed or contemplated in this agreement.

On depositing his bonds with the designated depository trust company the bondholder will be given a certificate of deposit, which will read somewhat as follows: —

Certificate of deposit of five per cent general mortgage bonds of the X. Y. & Z. Railroad Company, under deposit agreement dated May 28, 1916, between Thomas Brown, Henry Robinson, John Jones, Robert Smith, and Richard Ames and the holders of the five per cent general mortgage bonds of the X.Y. & Z. Railroad Company.

The Manhattan Trust Company of New York hereby certifies that it has received from five per cent general mortgage bonds as above stated, subject to the terms and conditions stated in the above-mentioned deposit agreement. The holder hereof assents to and is bound by the provisions of said agreement by receiving this certificate and is entitled to receive all the securities, benefits and advantages to which the depositor of said shares is or may become entitled, pursuant to the provisions of said agreement. The interest

represented by this certificate is assignable, subject to the terms and conditions of said agreement, by transfer upon the books kept by this company for that purpose by the holder hereof in person or by attorney, upon the surrender of this certificate duly indorsed for transfer.

NEW YORK, , 1916.

The Manhattan Trust Company of New York

By.....

Vice-President.

.....

Assistant-Treasurer.

Registered

The Financial Trust Company, Registrar,

By.....

Assistant-Secretary.

For value received hereby sell,
assign and transfer unto the
within certificate and all rights and interests
represented hereby, and do hereby irrevocably
constitute and appoint attorney, to
transfer the same on the books of the said trust
company, with full power of substitution in the
premises.

Dated , 1916.

..... (L. S.)

In Presence of

.....

Though the form given shows a registered certificate transferable only by change of registration, such receipts may be issued to.

run to "bearer." The registered form is usual, however, and an endorsement of the power of attorney in blank makes it sufficiently negotiable.

Of course, the purpose of issuing these certificates, besides their immediate service as a receipt, is to supply the bondholder with something he can sell. If the issue now in default had a market when it was not in default, the course of dealings will continue after the default at prices representing the condition and prospects of the security. Dealings will take place in the deposit certificates just the same as in the security itself. Note the statement in the protective committee announcement shown a little later that: "Application will be promptly made for listing the certificates of deposit on the New York Stock Exchange. In fact a course of dealings will go on side by side in the deposit certificates and in the undeposited securities, and a slight difference in the quotations may arise depending on an opinion as whether it is more advantageous to have deposited or not to have deposited.

Though the bondholder who does not at once deposit his bonds may be taking a position which somewhat resembles that of the dog in the manger, he is nevertheless making a fairly good speculation in not depositing

quickly. Every protective committee necessarily involves some expenditures which the depositing bondholder will have to bear in the proportion that the number of bonds he deposits bears to the total number of bonds deposited. The members of the protective committee are entitled to some compensation for their services. The depository agreement should specifically provide for the amount of this compensation, or the means of determining what the compensation should be. Probably they will have counsel fees to pay. There will be incidental expenses of printing, clerical assistance, postage, the fee of the trust company for acting as depository, etc. The various expenses may run to a considerable total. Though the amount apportionable to each bond deposited will not be great, it will nevertheless amount to something, perhaps from one half to one and a half per cent. If the committee is not able to bring about a reorganization and dissolves without accomplishing anything substantial, those who have deposited will have to bear this expense and will be no better off than those who did not deposit. Usually the desire of the committee to get as many bonds deposited as possible leads to its allowing a considerable period at the very start within which to deposit, and from time to time to announcing

an extension of the original time for deposit. So the bondholder who does not deposit at once is likely to have the opportunity open to him for a considerable period, and as time elapses he may be able to see more clearly whether it is desirable for him to deposit or not.

On the other hand, if a sufficient number of bondholders adopt this Fabian policy, they may so delay the process of reorganization as to cause loss to all bondholders, including, of course, themselves. So if the committee which solicits the deposit of his bonds is satisfactory, he may regard it, not only as a duty of loyalty, but his best financial policy, to deposit his bonds, and by so doing add all the strength he can to the committee, and by giving it strength lead to the coming in of the Fabian ones.

The following announcement of a protective committee will illustrate some of the statements made: —

To holders of Missouri, Kansas & Texas Railway Company 100-year second mortgage 4 per cent gold bonds, due June 1, 1990, interest payable February and August 1st —

The interest due and payable February 1, 1916, on the above described bonds has not been paid.

At request of the undersigned committee, formed for the protection of these bonds, the trus-

tee under the mortgage has intervened in the foreclosure proceeding now pending, and has filed its petition asking the court to order payment of interest on the bonds.

It is essential that holders should immediately deposit their bonds, with all unpaid coupons attached, with the Union Trust Company of New York, Depository. The committee will continue to receive deposits of bonds until the close of business on June 15, 1916, and, thereafter, only upon such conditions as the committee may determine.

The depository will issue certificates of deposit therefor under a deposit agreement dated December 23, 1915, copies of which may be obtained from the depository.

The deposit agreement provides an opportunity for any depositing bondholder to withdraw, in case any plan of reorganization formulated is not approved, on payment of a proportional share of expenditures and obligations of the committee, which share is limited to the amount, or rate, of \$10 for each \$1000 face value of bonds deposited.

Application will be promptly made for listing the certificates of deposit on the New York Stock Exchange.

New York, June 2, 1916.

G. K. B. WADE, *Secretary*,
80 Broadway, New York.
SPOONER & COTTON,
Counsel.
UNION TRUST COMPANY OF N.Y.,
Depository,
80 Broadway, New York City.

EDWIN G. MERRILL,
Chairman,
LEWIS L. CLARKE,
P. J. GOODHART,
W. J. MATHESON,
D. E. POMEROY,
Committee.

Note the statement of the limitation of expenses. This encourages depositing by letting the depositor know the limit of his liability.

If the bonds in default are a large issue, part of which has been sold abroad, banks at the financial centers of the countries in which the bonds are largely held will be appointed depositories for the foreign bondholders. Foreign bondholders may organize a protective committee of their own which may decide to coöperate with the American committee, or may oppose it in some or all of its proposals. In the designation of depositories the committee aims to make it as easy as possible for the bondholders to deposit and to present them with institutions sufficiently well known to them to have their confidence.

What has been said of the committee of the holders of the principal defaulting issue applies generally to the various protective committees of the other issues. Each committee desires to have deposited under its agreement as large a proportion as it can possibly get of the issue it seeks to represent. Just as the diversity of interest of bond issues of different securities makes it necessary to have separate trustees for the several issues, so the diversity of interest, when the business is looking toward a reorganization,

makes it desirable to have different depositories for at least the more important issues. Of course, the situation is not at all the same in the case of the protective committee depository as with the trustee. The trustees of different issues may actually have to take action in opposition to each other. The depository under a bondholders' agreement is filling a purely administrative function. Discretionary action lies with the committee itself. Still it looks better, and is better, to have different depositories.

Immediately on the default, and simultaneously with the filing of the bill applying for the appointment of a receiver, the protective committee organized for the principal defaulting issue will give notice of its formation by extensive advertising, in which it will solicit the holders of bonds of the issue to make the committee their representative by depositing bonds under the protective agreement prepared. The extent to which this agreement grants specific powers to the committee makes it run into a considerable document. Regularly it is printed as a pamphlet, and the bondholder may, if he wishes, procure a copy from the depository trust company. Its provisions will be drawn so that the committee can count upon the bonds during the life of the agreement, or until the reorgani-

zation plan is announced. Arranging for a reorganization is a tedious process and is likely to extend over several years. So it is desirable to make the life of the committee run for five years before it expires by limitation of time.

Meantime, after the bill for the appointment of the receiver has been prepared, and the protective committee agreement drafted, counsel for the management trying to steer a safe course through reorganization will be preparing the foreclosure suit, which they will begin as soon as possible after the appointment of the receiver. It will be their aim so far as possible to avoid the delays and complications of intervening parties. We have assumed that the holders of a majority of the bonds of the issue have deposited their bonds with the depository of the "official" committee. If the minority bondholders, or any part of them, have organized under a separate committee, counsel for the majority committee bringing the foreclosure suit may welcome the intervention of the minority committee in the foreclosure action in order that it may appear conclusively that the minority holders have had their hearing.

The mortgage regularly gives the trustee the right to other remedies besides foreclosure. It provides that the trustee, in the

event of a default by the corporation, may take possession of the mortgaged premises and operate the road and otherwise manage the business until the money due under the mortgage is either paid or provided for. When the trustee has taken possession under this provision, the trustee may, under the regular provisions of the corporate mortgage, also sell the property to satisfy the claims of the bondholders. The mortgage further authorizes the trustee, without first taking possession of the property, to sell it at public sale.

As a matter of fact these special remedies stipulated for in the mortgage are not taken advantage of. They raise perhaps too many questions of the rights of other parties. Yet the lawyer drawing the mortgage would not think of leaving them out. They are additional rights and protection, and a situation might conceivably arise when they would prove useful. But the path to settlement by way of the receivership and foreclosure is too well worn and relatively easy to travel to be departed from unless very exceptional circumstances should arise.

One of the first steps looking toward a foreclosure of the mortgage, after the action is brought, is to have an examination and appraisal of the property. This looks toward determining its real condition and value, and

when done will be helpful, especially in determining what shall be the minimum price at which it may be sold under foreclosure. Such minimum price is called the "upset price," and means that at the foreclosure sale no bid below the upset price will be received. In the case of a large railroad property this examination is bound to take a year or two. Engineers will have to go over the entire mileage and report on the physical condition of the property. Expert accountants will go over the books and make an auditor's report. A reorganization of a large railroad involves a great deal of real work. This discussion will probably give the uninitiated some idea of the reason why it usually takes several years, even with no especially unfavorable developments, to complete the process.

It is the duty of the trustee under the mortgage to bring the foreclosure suit. The bondholders bring the action directly only in case of the neglect or refusal of the trustee to act. The trustee is the mortgagee and the proper party to appear. The mortgage contains elaborate provisions for guidance in the event of foreclosure. Some of these are concerned with the protection of the trustee and are inserted in the mortgage at the trustee's instance. The trustee cannot be compelled to bring the action unless first given an indem-

nity against any liabilities it may incur in the course of the proceedings. Of course, the trustee has no real financial interest in the proceedings, and those who are attempting to guide the business through to reorganization will probably supply most of the energy necessary to push the matter along. They will find it desirable to push it as rapidly as possible, because the longer the matter is delayed the greater opportunity is given for hostile forces to arise.

With the foreclosure suit entered and the appraisal under way, those who are in charge of the movement toward reorganization will begin to work on the reorganization plan. All the work of reorganization looks forward, of course, to the formation of a new corporation, under such conditions and with such a plan of capitalization as will enable it to operate the railroad or continue the enterprise and meet its obligations. We will consider later the financial considerations of the new financial plan and its aim of reducing fixed charges to a point where the business can meet them.

Obviously a large railroad system cannot be bought offhand like a piece of second-hand furniture at an auction sale. The magnitude of the transaction requires that it be carefully prepared for. Even though the property is sold at public sale, as a matter of course

there is only one bidder, the group which has been in charge of the reorganization proceedings all along, and has carefully prepared its plan and arranged for the necessary financial backing. It is the magnitude of the enterprise that requires the holders of the defaulted securities to provide for carrying on the business in order that they may realize something on their investment. If the bondholders saw a chance of various outside interests coming forward and bidding for the property in such a way that it would realize approximately its actual value, then they would be very glad to let somebody else buy it, and they would take their share of the proceeds. But the only way they can actually realize the fair value of the property is to take the property itself for themselves. The foreclosure proceedings are gone through with to fix definitely the rights of all the parties in interest and to permit the business to go ahead on a well-defined basis. Because those who have been in charge of the proceedings have a well-organized plan and financial backing arranged, they are prepared to purchase the property at the foreclosure sale.

The statutes of some States expressly provide that the purchasers of a railroad property at a foreclosure sale do not need formally to incorporate. Such States incorporate the

business through the operation of the law by reason of the fact itself of the purchase under foreclosure. In the absence of such a statute, if the new corporation is not already formed by the time of the foreclosure, those in charge of the reorganization can effect the purchase and hold and operate the property as individuals until the new corporation is formed and ready to take over the property.

A railroad corporation involves two distinct franchises, the franchise to operate the railroad and the franchise to be a corporation. It is not necessary to be a corporation in order to enjoy a franchise to operate, and the fact of being a corporation does not in itself give the right to operate. Sometimes the franchise to operate is expressly mortgaged and passes to the purchaser at the foreclosure sale. Though many States forbid the corporation to mortgage its franchise to operate, nevertheless on a foreclosure sale this franchise passes to the purchaser. Many technical legal considerations revolve about this point, and we will not discuss it further here, but assume that the franchise to operate effectively passes under the foreclosure.

The next matters in the process of reorganization center about the reorganization agreement. These matters may be summarized as: —

The financial plan.

The reorganization agreement.

The filing of the reorganization agreement with the depositories and advertising the filing.

Giving depositors an opportunity to withdraw.

Declaring the plan operative (or inoperative).

We have already mentioned the idea of the financial plan of cutting down fixed charges and providing the cash necessary to put through the reorganization. The big work of the reorganization comes in arranging a financial plan that will accomplish these results and at the same time be acceptable to a sufficient number of the parties in interest to enable it to be put through. We will reserve for the present a discussion of the principles and difficulties involved in drawing up this plan and assume that the reorganization committee has done the best it can. For at this point the various protective committees agree on a new committee which will go ahead and directly plan the details of the reorganization. Though it will, of course, represent principally the interests of the protective committee for the issue most concerned, its duty will be to formulate a plan which will, if possible, win the adherence of the other protective committees.

The reorganization agreement provides for the consent of the various parties in interest that the reorganization may be carried

through under the financial plan proposed. Note that this is the second agreement which the security-holder is asked to make. The first, the depository agreement, under which he was asked to deposit his securities with some trust company and constitute the protective committee his agents for taking steps toward a reorganization, we have already discussed. The reorganization agreement names the managers whom the reorganization committee has decided upon. They are likely to be one or more of the banking houses which have in the past handled the financing of the corporation, and which are therefore interested in having the reorganization as successful as possible. The reorganization plan itself needs to win the adherence of the various protective committees, and the managers under it must be such as to meet with the approval of these committees.

Recall that each protective committee, in soliciting the adherence of the holders of securities of the issue for which they sought to act, designated some trust company or bank with which the holder was asked to deposit his security. Copies of the financial plan and agreement will be filed with each of these depositories. The fact of the filing will be advertised in the city of each depository bank or trust company. It is also customary

for a committee to advertise in any cities in which the securities have been sold to any large amount and if any considerable amount of the securities has been sold abroad, a committee will advertise there also. Since the certificates of deposit the security-holders have received are negotiable, in the sense that the rights under them may be made to pass by delivery, the protective committee does not know just what individuals may constitute the parties in interest at the particular moment. So this advertising is necessary to give notice of the situation. The reorganization agreement will provide that security-holders who have deposited their securities under the provisions of the protective committee's agreement may withdraw their securities within a stated time, say twenty days, and that if they do not withdraw they will be presumed to have assented to the terms of the reorganization agreement. If they withdraw, they must, of course, surrender the certificates of deposit they received when they deposited their securities under the protective committee agreement. If they do not withdraw, these same certificates will continue to represent their interest in the reorganization agreement. At this time another opportunity will be given to security-holders who have not already deposited their securities to come in

and deposit. When they do so they will receive a certificate of deposit just like that of those who have already deposited. Naturally any one depositing his securities at this late date will be required to assume as large a proportion of the expense of the protective committee as if he had deposited at the very beginning. In fact, the protective committee's depository agreement probably limited the time within which the security-holder could deposit, but left it in the discretion of the committee to extend this time. It is so desirable that the committee control as many bonds as possible that this time limit is likely to be extended and perhaps extended again several times before finally further opportunity is given to deposit after the filing of the reorganization agreement. The original depository agreement may have provided that if a holder did not deposit within the time limited he could subsequently deposit only on the payment of a penalty. The penalty would be fixed at perhaps one per cent, or \$10 a bond. The protective committee will adopt whatever policy as to depositing it thinks likely to give it most strength. But, of course, it would be unfair to the earlier depositors if people who came in subsequently were not obliged to bear their full proportionate share of the expenses. Filing the reorganization

plan and agreement marks one of the critical times in the process of a reorganization. How many of the deposited bonds will be withdrawn? How many bondholders who have stayed out heretofore will come in and deposit now that they know definitely the terms of reorganization? When the shift is over, will the result justify declaring the plan operative?

Another situation now needs further explanation. We have mentioned the appraisal of the property as helping the court to fix the proper upset price for the foreclosure sale. This is one of the delicate and critical matters of the procedure. Some of the bondholders will refuse to become parties to the reorganization agreement. Their refusal to enter into this agreement cannot, however, deprive them of their rights as bondholders. The property must be sold at a definite price. The bondholders who become parties to the agreement undertake to accept new securities, under such conditions as the agreement indicates, in settlement of their rights under the foreclosure which they have entrusted to their protective committee. Let us assume that a sufficient number of bondholders join in the reorganization plan to make the managers feel justified in declaring it operative. At the time of the foreclosure sale the managers will have to be prepared to bid for the

property, and the upset price will indicate the lowest price which will be accepted as a bid. Each bondholder is entitled, so far as the foreclosure proceedings are concerned, to his proportionate share of the price established at the sale of the property as the selling price. Those who have joined in the reorganization agreement, however, have cast their lot with the property or business itself, and to that end have given the reorganization managers the disposition of their interest in the proceeds of the foreclosure. Since this is the regular and normal thing, the procedure will provide for cutting out some of the motions that simply counteract each other. Let us assume, as ordinarily the case would be, that a property is being sold at the foreclosure subject to the underlying mortgages. We will also assume that the court has named \$16,500,000 as the upset price, and that of this amount it will take \$1,500,000 to provide for obligations of the receiver and other obligations which the court requires to be taken care of. This will leave \$15,000,000 as that part of the proceeds which would be available to satisfy the general mortgage bondholders. We will assume that the mortgage secures an issue of \$20,000,000. That is to say, at the price named the general mortgage bondholders are entitled to seventy-five cents on the dollar of the par value

of their bonds. If this entire amount of \$16,500,000 were to be paid in cash at the foreclosure sale, it would mean that every general mortgage bondholder would get for each \$1000 bond \$750 in cash. Then those bondholders who want to stay by the property and have come in under the reorganization agreement would simply pay back the cash for the next securities provided for by the reorganization agreement. If the business were ever put through in this way, it would mean probably that the reorganization managers had borrowed a large porportion of the amount required to be paid at the sale, and would repay the loan when they were paid back by the bondholders who had agreed to the reorganization plan. To require the reorganization managers, when purchasing the property under the foreclosure, to pay the full purchase price in cash, most of which they would have to borrow until the very money they paid was paid back to them on presenting the bonds which had been deposited with them, would greatly embarrass the process of reorganization. So, when the managers make their bid at the foreclosure sale and have the property awarded to them, they are permitted to make payment in part with the bonds which have been deposited under the reorganization agreement. That is to say, since

every bondholder would have received seventy-five cents on the dollar, if the foreclosure price were paid in cash, then the purchasers at the sale will be permitted to make payment in bonds which will be received in payment at the rate of seventy-five cents on the dollar.

Let us assume that 95 per cent of the bondholders deposited under the reorganization plan. Then the reorganization managers have \$19,000,000 of bonds they can pay in as part payment of the purchase price. That is equivalent to a payment of \$14,250,000 and leaves \$2,250,000 of cash to be provided.

Since it is not within the bounds of probability that any holder will appear at the foreclosure sale other than the reorganization managers, the upset price which, within every reasonable expectation, will become the purchase price, assumes a large importance in the reorganization process. The court must be careful to fix it high enough to give the depositing bondholders everything they are justly entitled to get out of the property. Exactly what they are justly entitled to get may be very difficult to determine. No matter how active a market there may be for railroad securities, there is not an active market for whole railroads. However, the appraisal of the general investing public —

that is, the market values of the securities — is shown by such dealings as there may be in them. The present earnings and condition of the property will be helpful in arriving at some conclusion about what may be fair terms for the minority non-depositing bondholders.

Since the majority is essentially buying out the minority interest, the value of which is being fixed on the basis of the value of the entire property, the majority, represented by the reorganization managers, want that value for present purposes estimated as low as possible. If they have to pay the minority holders too great an amount for their interest, the purchase of the property will not be a desirable one. The price may be absolutely too great, — that is, more than the interest is really worth, — or it may simply involve the payment of more cash than the managers can provide the means of raising.

Assuming that the reorganization managers do not regard the price as too high, how will they provide whatever cash may be necessary? This question brings us to another aspect of the reorganization. The plan of reorganization shows the means the managers have provided for raising the cash. But they must have some assurance that these means will prove sufficient. So the bankers interested

in the reorganization will enter into an agreement with the reorganization managers underwriting the cash requirements; that is, guaranteeing the sufficiency of the means provided in the financial plan of the reorganization. The bankers, in turn, to protect their position will form an underwriting syndicate. This banking transaction does not differ in any essential respect from the assumption and shifting of risk involved in any purchase or underwriting of securities and the formation of a syndicate as described in an earlier discussion. Whatever the precise form for raising cash which the plan of reorganization may set out, it will amount essentially to selling some of the new securities provided for in the new plan of capitalization.

The means which a reorganization plan may provide for meeting the cash requirements of the reorganization are ordinarily thought of as two: (1) an assessment of the stockholders of the old corporation; (2) the selling for cash of some of the bonds or other securities arranged for in the reorganization plan. Though thought of and spoken of as separate means, both come really to the same thing, a selling of some of the securities of the new corporation for cash. The first means is usually stated somewhat in this way: On the payment of \$20 for each share of the stock of

the old corporation against which the foreclosure proceedings are being taken, the stockholders of the old corporation will be given a share of stock in the new corporation on purchasing a par value of a certain issue of bonds of the new corporation at a certain price. The manner in which this is put sometimes has the superficial appearance of "taking care of" the stockholders of the old corporation and recognizing that they have still an equity in the property. In most cases the appearance of preserving an equity will vanish on closer examination, and it will be seen that the amount of what is called an assessment on the old stock is based upon the anticipated value of the stock of the new corporation, or the combined assessment and price to be paid for the new securities amounts to the estimated value of the new securities to be received. In a word, the so-called "assessment" is really a purchase of the new securities.

No holder of the old stock can be obliged to pay the assessment and purchase the new securities. When he bought his stock it was fully paid-up stock, and the liability of the purchaser was absolutely limited to what he had already put into it. Of course, there is nothing to prevent him from entering into special agreements over the stock that will

create new liabilities, but these new liabilities do not and cannot arise from the mere fact of his existing status as a stockholder. If he deposits his stock at the instance of a protective committee signifying his joining in the depository agreement, he creates new liabilities in connection with his stock. His status as a stockholder precludes any obligation to deposit his stock. So when the so-called "assessment" is made it cannot impose any duty to assent to its terms and become bound to its obligations.

The situation may strongly invite the stockholder, however, to pay the so-called "assessment." Most people feel a distinct aversion to marking entirely off their books anything they have ever carried as an asset. If the stockholder does not come in and pay the assessment, he must confess to himself that he has suffered a total loss and has no possibility of salvage. His interest in the enterprise will be entirely gone. He feels that the property owes him something. It does. It owes him whatever he invested in purchasing the stock. He feels a natural creditor's desire to collect some of the debt if possible. His only chance of collecting from the property some of the debt it owes him is to advance some more money to it, and, by helping get it under way in its reconstituted form,

hope that it will ultimately pay him back more than the additional amount he is now putting in. Though the investment may be good, the motives on which it is made rest upon a subconscious reasoning that is mostly fallacious. However, these motives are often taken advantage of to raise, or help raise, the cash requirements of the business in reorganization.

The other method of raising cash accomplishes the same result with less appearance of indirection. In arranging the capital plan of the new organization the managers will make one or more of the new bond issues large enough so that part of the issue will be available for sale to raise additional cash beyond the amount necessary for the requirements of distribution among the depositing bondholders.

If the so-called "assessment" plan is tried, and managers estimate that all or any given percentage of the old stockholders paying the assessment would provide the cash needed, then the underwriters have to be prepared to stand in the breach and provide any part of the necessary cash which the old shareholders do not supply. As already stated, this procedure is in no sense different from that of any underwriting syndicate operation. If the new funds are to be provided by the

sale of bonds, then the position of the underwriters is just the same as in the case of a syndicate purchasing any issue of securities.

It should be pointed out that the assessment method is not confined in its operation to the common stockholders or to any other class of stockholders. The reorganization plan may apply it to any class of security-holders junior to the issue on account of which the property is being foreclosed or even to that issue itself. If in case of the capitalization plan presented at the beginning of this discussion, for example, the default had been in the first and refunding $4\frac{1}{2}$'s, the chance to pay an assessment and participate in the reorganization might have been presented to the holders of the general mortgage 5's. With the foreclosure at the instance of the holders of the general mortgage 5's the assessment plan may be presented to both the preferred and the common stockholders. Each situation presents its own aspects, and the reorganization managers must decide on the best methods. Most reorganizations utilize the psychological appeal of the assessment, either alone, or combined with a more frank selling of new securities.

* If an assessment forms any part of the reorganization plan, presumably the cash will be called for before the foreclosure sale, to be

— returned if anything should still prevent the reorganization from being accomplished. It may be remarked that for the series of reorganizations which Mr. Stuart Daggett considered in his book on *Railroad Reorganizations*, he points out the fact that a short time after the reorganization the new securities could regularly have been bought at less than the assessment price.

Obstructionists are most likely to appear in connection with the fixing of the upset price. If the price is placed too high the reorganization managers and their supporting syndicate cannot carry the reorganization through. It will require more cash than they can raise without jeopardizing the success of the reorganizing enterprise. Minority holders may endeavor to get the price higher simply for the direct benefit that may accrue to them. It should be remembered, however, that a minority holder may have a much more important interest in some other issue and may be seeking to get a better bargain for the other issue. This is not a legal treatise, and we will not go into a discussion of all the legal resources of those who are trying to make better terms. Even though their contentions might ultimately be rejected absolutely, time is of the essence with the reorganization syndicate. It has made its

agreement with the reorganization managers on the basis of existing financial conditions. These may change at any time and make the transaction on the proposed terms a certain loss. The reorganization managers may deem it business expediency to make terms with objectors which the managers do not regard as really just, but which they are financially able to meet. The objectors have a "nuisance" value, and sometimes are very well aware of the fact. Objectors may, however, simply cause such delays as to prolong the situation beyond the time for which the syndicate is bound, and it may then throw up the entire matter. The necessary time limit of its agreement with the syndicate puts the reorganization committee under pressure to be able to declare the plan operative within the time allowed.

In connection with the discussion of cash requirements we will quote the statement of the provisions for this purpose made in the reorganization plan, dated November 1, 1915, of the St. Louis & San Francisco Railroad Company: —

Provision for cash requirements

For the purpose of meeting the estimated cash requirements of the plan, Messrs. Speyer & Co., J. & W. Seligman & Co., Guaranty Trust Company of New York, and Lee, Higginson & Co.

have undertaken to form a purchase syndicate, of which they will be syndicate managers. The purchase syndicate, among other things, will

(a) purchase

\$25,000,000 prior lien mortgage bonds, Series B (five per cent);

\$43,180,000 common stock (trust certificates), for the sum of \$25,000,000 (and accrued interest on the bonds), against which will be credited the amounts paid by stockholders as a condition of participating in the plan, and will offer the prior lien mortgage bonds and common stock (trust certificates) so purchased, to the extent and on the terms stated in the plan, to depositing holders of stock who shall have complied with the conditions of the plan;

(b) purchase at the request of the reorganization managers additional prior lien mortgage bonds, to an amount not exceeding in the aggregate \$5,000,000.

No provision has been made for underwriting the cash required for payment to holders of non-assenting refunding mortgage bonds and general lien bonds of their distributive share of the proceeds of the foreclosure sale, as, in the judgment of the reorganization managers, the failure to deposit undeposited bonds has been in the main due to existing conditions in Europe, where such non-deposited bonds are mainly held, but it is intended, on the completion of the reorganization, to set aside, under such restrictions as the reorganization managers shall deem proper, the new securities and cash to which, under the plan, hold-

ers of non-deposited refunding mortgage bonds and general lien bonds would be entitled if deposited under the plan, if deemed practicable until the expiration of one year after the conclusion of peace by treaty, to be deliverable on the terms stated in the plan, at any time during such period, to holders of such bonds who may desire to avail themselves of the benefits of the plan and shall give satisfactory reason for their previous inability to deposit the same under the plan; the securities and cash deliverable in respect of any non-deposited bond to be available for providing, if necessary, the moneys required to pay the cash distributive share of such bond. Such refunding mortgage bonds deposited under the agreement of June 20, 1914, and such general lien bonds deposited under the agreement of May 28, 1913, as may be withdrawn from said respective agreements, will not be entitled to avail themselves of such provision.

Guaranty Trust Company of New York has undertaken to form a loan syndicate, of which it will be syndicate manager, which among other things will, against the pledge by the purchase syndicate of such of the prior lien mortgage bonds and common stock (trust certificates), specified in subdivision (a) above, as shall not be purchased and paid for in full by depositing stockholders, and reserved against fully paid subscription certificates, agree to advance to the purchase syndicate, up to ninety per cent of the face amount of said bonds so pledged. The loan syndicate will agree to make, for account of the purchase syndicate, deliveries in accordance with the

terms of the purchase warrants, to holders thereof complying with the terms of such purchase warrants.

The reorganization managers for their services shall be entitled to compensation in such usual amount as shall be determined to be fair by the persons, or a majority of them, who at the time of such determination are respectively Presidents of The New York Trust Company, Columbia Trust Company, and The Equitable Trust Company of New York.

The compensations and commissions to be paid to the reorganization managers and the respective syndicates are to be paid as part of the expenses of the reorganization. The reorganization managers may become participants in either syndicate.

Finally the day set for the foreclosure sale arrives. The reorganization committee, or a subcommittee of it, attends the sale prepared to submit its bid based on the upset price already set by the court. As already remarked, it would be an extraordinary thing for an unexpected bidder to appear. The court has fixed the upset price on the basis of what the reorganization committee can afford to pay for the property. No one else could afford to pay as much, because any one else would have to provide so much more cash. The reorganization committee can make a large part of the payment in bonds of

which it holds a substantial majority, or else it would not have declared the plan operative. A minority bondholders' protective committee could not pay so large a proportion of the purchase price in bonds, and any one else would have to pay the entire purchase price in cash. We have already seen that providing the necessary actual cash is one of the crucial points of a reorganization undertaking, even for the majority bondholders. Since they do not need to provide as much cash as any one else they have a great advantage at this point over any other possible bidder. Now that the reorganization committee has done so much work, it does not, however, want to lose the purchase of the property through the submission of a bid only a trifling amount, as a dollar or two, higher than its own. Through the requirement of the cash deposit, making bidders disclose their intention of bidding, the committee will know of any competitors, estimate their strength, and conduct itself accordingly.

The decree of foreclosure which the court has made provides all the conditions governing the sale. Just as for any bidding, it provides that a substantial cash deposit shall be made with the bid to assure the good faith of the bidder. If the bidder commits any fraud in connection with the proceedings, the sale

may be subsequently upset. After the sale has been made, it must go back to the court for its confirmation.

Assume that the court names as an upset price a sum less than the amount of the mortgage under which the foreclosure proceedings have taken place. Of course, it is the regular situation that the sum is smaller than the face of the mortgage. In the case of a railroad, the mortgage foreclosed is so generally a blanket mortgage covering the entire assets of the corporation that the deficiency judgment for the difference between the sale price and the face of the mortgage would have no value. The foreclosure of a mortgage on an industrial enterprise would not so invariably involve all the assets of the corporation. Since, however, the business and assets must be sold as those of a going concern, the decree would provide for the sale of all the property, and in the event that not all were under the mortgage the deficiency judgment might have some value.

One element of uncertainty in reorganization becomes increasingly important. Public service commissions more and more have jurisdiction over capitalization. Where they have jurisdiction their approval must be obtained for the capitalization proposed for the reorganization of a public service enterprise.

Delay caused by the necessity for satisfying a public service commission may result in the failure of the attempt to reorganize.

Let us assume that the reorganization committee has taken every step successfully, and that the new securities, either in the form of interim receipts or definitive certificates, are ready for distribution. The depository certificates which so far have represented the depositors' interests in the reorganization were transferable, and the committee has no means of knowing who now are entitled to the new securities. Therefore the committee will publish notice that the new securities are ready for distribution.

It is likely to be one of the provisions of the reorganization agreement that the stock of the new corporation shall be placed in a voting trust. The reorganization syndicate wants the voting trust in order to insure continuity of management, and to avoid embarrassments that would result from the hostility to the management of a voting minority. As a result of the consideration they have given the enterprise on account of the default in its obligations, those who are interested in the reorganization have probably formed a definite idea about what policies will be most advantageous to the business. These policies are likely to involve a large construc-

tive work of business organization which will take the management several years at least to carry out. To meet the requirements of the Stock Exchange Listing Committee and of state law, the trust agreement is ordinarily made for a period not exceeding five years. The wording of a reorganization plan establishing a voting trust follows: —

The preferred and common stock of the new company issued in the reorganization will be assigned (but in the event hereinafter stated, subject to the prior pledge thereof) to the following voting trustees: Frederic W. Allen, James W. Lusk, Charles H. Sabin, James Speyer, Frederick Strauss, Eugene V. R. Thayer, and Festus J. Wade, and be held by them, jointly, and their successors (under a trust agreement prescribing their powers and duties and the method of filling vacancies), for five years. The voting trustees will issue certificates of beneficial interest entitling the registered holders thereof to receive, at the time and on the terms and conditions stated in the voting trust agreement, stock certificates for shares of the number and class specified in such certificates, and in the meanwhile to receive payments equal to the dividends received by the voting trustees upon shares of the number and class therein specified. In the event of the death or failure or refusal to serve of any person designated as a voting trustee, prior to the creation of the voting trust, the vacancy shall be filled by the reorganization managers.

If, in their unrestricted discretion, the reorganization managers shall so determine, the preferred and common stock of the new company issued in the reorganization may be pledged as additional security for the prior lien bonds for five years, and for that purpose be vested in the corporate trustee under the prior lien mortgage by agreement made or approved by the reorganization managers, under which the voting power on the stock so pledged shall be exercised by the corporate trustee under the prior lien mortgage as from time to time directed by the voting trustees, or, in the absence of such direction, or in case of default in the payment of any installment of interest on any prior lien bond, as directed by a majority of the corporate trustees under the prior lien mortgage, the adjustment mortgage and the income mortgage.

Now that we have considered the general procedure of a reorganization, let us take up the specific problem presented in the beginning of our discussion, the reorganization of the X. Y. Railroad Company. We will assume that the divisional bonds shown in its capitalization bear interest averaging five per cent for the \$10,000,000. This makes fixed charges on account of: —

Divisional bonds, interest.....	\$500,000
First and refunding 4½'s, interest.....	1,125,000
	<u>\$1,625,000</u>

The corporation has not defaulted on these obligations, its earnings are ample to provide for them, and no one at any time has thought of disturbing them in the reorganization. Besides the fixed charges the corporation is subject to an account of these defaulted securities, the interest obligation on account of the securities in default amounts to: —

General mortgage 5's, interest.....	\$1,000,000
Collateral trust 5's, interest.....	250,000
	<u>\$1,250,000</u>

Or, total fixed charges of the system at the time of default were \$2,875,000. Net earnings at the time of default were, let us say, \$2,750,000. The receiver has been able, during the term of his operation of the property, to increase the net, we will assume, by \$50,000, and makes a showing at the time the reorganization plan is finally formulated of net earnings of \$2,850,000. Since he has increased fixed charges by \$30,000 through the issuance of \$500,000 6 per cent receiver's certificates, the increase of \$50,000 in net does not represent a real gain for the full amount of the increase.

The reorganization committee is confronted with the problem of two issues in default, each with a lien on separate pieces of property. It is important, however, in the interests of both pieces of property that the system be

kept together, and in order to keep them together it is necessary that a plan be formulated that will be just to both classes of security-holders. To form such a plan involved an examination into the relative merits of the two properties. It was found that at the time of the default the net earnings of the X. Y. system proper were \$2,525,000. Interest on the issues secured on this property, the two underlying issues and the one in default, required \$2,625,000. This made a deficiency of earnings of this part of the system of \$100,000, or a deficiency of 5 per cent on the amount required to meet the interest charge on the general 5's in default. Net earnings of the M. X. Railroad, the branch line, all of the bonds of which are deposited to secure the M. X. Railroad collateral 5's, amounted to \$225,000. Interest requirements of the collateral 5's called for \$250,000. This presented a deficiency in earnings of 10 per cent of the amount required to meet interest charges on account of this issue. Holders of the collateral 5's have the advantage, however, of not having any claim on the M. X. Railroad property ahead of theirs. We will assume that this and other considerations, such as the relative physical condition of the two properties and their relative importance to each other, led the reorganization

committee to the conclusion that the general mortgage 5's and the branch line collateral trust 5's should stand on the same basis in the reorganization. Such a conclusion, of course, simplifies the problem of our reorganization plan in providing equivalents for the securities which the new plan will displace.

We must now consider what success the reorganization committee has met with in getting deposits of the defaulting securities. Again we will simplify our computations by assuming that the same per cent of each of the issues refused to deposit, and place the amount at 5 per cent. So our reorganization committee had to consider —

\$1,000,000 general mortgage 5's not deposited.

250,000 collateral 5's not deposited.

This becomes important, as we know, in relation to the upset price the court may name for the foreclosure sale, which determines the amount of cash the reorganization committee must provide for raising through its plan. The committee is able to make such proposals that neither the majority nor the minority of the holders of the collateral 5's are disposed seriously to press for a separate foreclosure. They recognize the essential importance of the properties remaining together and content themselves with exerting such pressure as they can to get better terms.

After the case is fully before it — the appraisals of the property and the representations of the various parties in interest — the court establishes an upset price that will provide a payment of seventy cents on the dollar to the depositing bondholders of both classes. Now, let us consider what cash requirements the reorganization committee will have to meet. The committee estimates that the expenses of reorganization will amount to \$150,000. But this charge will be met directly by the depositing bondholders, and need not be considered here. There are \$1,000,000 of undeposited general mortgage bonds. The committee will have to provide \$700,000 to satisfy their claim. Of the collateral trust bondholders, those owning \$250,000 of bonds did not deposit. Providing for them will take \$175,000. There are \$500,000 of receiver's certificates outstanding and maturing so soon that their payment will have to be provided for, requiring \$500,000 more in cash. Miscellaneous claims, such as judgments for personal injuries, will take \$100,000. Immediate additional expenditures will have to be made on the property itself, for which the committee feels that it must provide \$810,000. Recapitulating cash requirements, then, we have: —

Non-depositing general 5's.....	\$700,000
Non-depositing collateral 5's.....	175,000
Receiver's certificates.....	500,000
Judgment claims, etc.....	100,000
Two years' interest overdue on \$20,000,- 000 bonds.....	200,000
Estimated cash requirements for the property.....	810,000
	<u>\$2,485,000</u>

Since the reorganization will require this amount of cash, estimate an un- derwriter's commission of two per cent on \$3,000,000 of securities.....	60,000
	<u>\$2,545,000</u>

Two items in these cash requirements call for some comment. It is customary to bring the interest payments on the old bonds up to date, so that the security-holders may feel that they have had a complete, though interrupted, income return. Of course, this is merely equivalent to making depositing bondholders a better offer by so much. The cash payment is especially good bait. The other item is the underwriting commission. We have already discussed the general principles of the formation of the underwriting syndicate. The financial backing may take the form of an underwriting or of an agreement to purchase any part of the securities to be disposed of for cash which the old stockholders do not subscribe for. We have here assumed the underwriting.

↪ In formulating reorganization plans, there-

fore, the committee faces the necessity of raising an immediate \$2,545,000 in cash. Besides raising this cash, it must also see to it that fixed charges are cut down to a point at which the net earnings will cover them with a sufficient margin to make another receivership improbable. Of course, the cutting of fixed charges had to be provided for before the committee knew just how much cash it would have to raise for the non-depositing bondholders, since the bondholders would have a right to withdraw on the announcement of the plan, and possibly some more might come in at that time. Our committee met the situation in a thoroughgoing way. It decided to offer holders of bonds half the amount of their par in interest-bearing securities, half the amount of their par in preferred stock, and to add to that a share of the new common stock for every \$1000 bond. They decided, too, that the new bonds should bear interest at the rate of only 4 per cent, as against the 5 per cent on the old bonds, and that the new preferred stock should be cumulative and entitled to preferential dividends of 6 per cent. The result would be that if the full dividend should be paid on the new preferred stock, the old security-holders would be getting the same income as before, and if anything should ever be paid on the new

common stock, that would be so much extra.
That is: —

Old security

Interest on \$1000 bond at 5 per cent. \$50

New securities

Interest on \$500 bond at 4 per cent. 20

Dividend on \$500 preferred stock of 6 per
cent. 30
\$50

We have assumed that 95 per cent of the holders of the defaulted bonds deposited them, and indications were that as large an amount would be on deposit when the plan should be declared operative. So the committee has to provide new securities for the owners of \$19,000,000 of general mortgage 5's and for the owners of \$4,750,000 collateral 5's. Since they are planning to give owners of each of these issues half their par value in new 4's, they will have to provide a total of \$11,875,000 of the new 4's to meet this requirement. An equal amount of new preferred stock will have to be provided to carry out the idea of the committee for the reorganization.

With the earnings of the corporation insufficient or barely sufficient to cover the dividend requirements, the committee can hardly count on selling the new preferred stock to provide cash. So it must provide an issue of the new 4's sufficiently large so that

some may be disposed of to furnish the ready money necessary. Since satisfying the old bondholders will require close to \$12,000,000, and since the new bonds will not be worth par, the committee will have to plan for about \$15,000,000 of the new bonds for immediate issuance. The committee feels the need, however, of looking forward to future capital requirements, and decides to make the authorized issue of the new 4's amount to \$20,000,000. The additional \$5,000,000 need not be considered in the immediate reorganization plans.

Let us see, now, what the fixed charges will be on the assumption that \$15,000,000 of the new 4's are to be presently issued:—

Interest on underlying bonds.....	\$500,000
Interest on first 4½'s.....	1,125,000
Interest on new 4's.....	600,000
	<hr/>
	\$2,225,000

Against these prospective charges the corporation net earnings now are \$2,800,000. On this showing of an amount available to meet the interest requirements of the new 4's of \$575,000 in excess of the \$600,000 demanded, the new bonds have a substantial value. Let us assume that the market is such that if they are made to run for the term of twenty-five years, as the committee plans, they should sell at 85, or approximately a 5.05 basis.

The reorganization committee has to consider the position of the preferred and common stockholders of the old corporation. In accordance with the principles already discussed, it wishes to give them an opportunity to participate in the reorganized enterprise and so forestall any endeavor on their part to block the reorganization, and at the same time to take advantage of the desire of such as may want to continue with the enterprise to raise part of the cash requirements. With a look toward this situation in particular and toward the rounding-out of the reorganization plan in general, the committee decides that the capital stock of the new corporation shall be \$20,000,000 of common stock, in addition to the \$12,000,000 of preferred stock already considered. The committee decides to give the preferred stockholders of the old corporation an opportunity to participate in the reorganization by allowing them, for each share of the old stock they hold, to purchase, by the payment of \$50, an amount of the par value of \$50 of the new 4's and \$100 of the new common stock. Since it is estimated that the new 4's should be worth 85, that would make that part of the purchase which is the \$50 in bonds have a value of \$42.50, and therefore be equivalent to letting the old preferred stockholder

buy the new common stock for \$7.50 a share.

Along the same lines the committee decides to let the old common stockholders for each share of the old common stock they own buy an amount of \$50 par value of the new 4's and \$75 par value of the new common stock on the payment in cash of \$50. Again, on the estimate of the new bonds being worth 85, this is making the new common stock cost the old common stockholders \$7.50 for each \$75 of par value, or at the rate of \$10 a share. Assuming that the new stock should be worth approximately this amount, this means that the old preferred stockholders are being permitted to realize a computed value of \$2.50 a share on their old stock. Since their claim is superior to that of the common stockholders, it is natural that they should be shown some preference in the reorganization.

Let us see how the committee is coming out with its common stock issue. To meet the distribution of one share of the new stock to each deposited bond will take \$2,375,000 of the new stock. If all the old preferred and common stockholders should want to participate, they would take more common stock than the committee has in mind to provide. Such unanimous participation, too, would

call for \$15,000,000 of the new 4's instead of the \$3,000,000 the committee has planned to dispose of to meet the cash requirements, and would provide \$15,000,000 in cash. Of course, no such result will follow the offer. Even for the preferred stockholders the computed value of the new securities offered them is so small that a small change in market conditions would wipe it out. The managers know that the syndicate to be formed to underwrite the reorganization plan will be remarkably fortunate if enough of the old stockholders come forward to supply all the cash needed.

We now have the new financial scheme of our hypothetical reorganization committee pretty well formulated. It results then in this manner: —

Securities untouched in reorganization

Underlying bonds averaging 5 per cent.....	\$10,000,000
First mortgage 4½'s	25,000,000

New securities

General mortgage 4's (authorized \$20,000,000)	15,000,000
Preferred stock, 6 per cent cumulative	12,000,000
Common stock	20,000,000

Summarizing the disposition of the new securities, we have: —

General mortgage 4's

To holders of old general mortgage 5's and collateral trust 5's.....	\$11,875,000
To be disposed of to meet cash require- ments.....	3,125,000
	<u>\$15,000,000</u>

Preferred stock

To holders of old general mortgage 5's and collateral trust 5's.....	\$11,875,000
To be held for disposition at any future time to meet the corporate require- ments.....	125,000
	<u>\$12,000,000</u>

Common Stock

To holders of old general mortgage 5's and collateral trust 5's.....	\$2,375,000
To satisfy subscriptions of old preferred and common stockholders (estimated)	2,000,000
To be held for disposition at any future time to meet the corporate require- ments.....	14,125,000
To syndicate for part of its compensation	<u>1,500,000</u>
	<u>\$20,000,000</u>

It will be noted that besides the cash commission stated in the list of cash requirements, we have provided the additional compensation of \$1,500,000 of the new common stock as shown in the list just given for the distribution of the stock. The old bondholders at whose instance the property is being reorganized would probably regard this provision as more advantageous for them than a larger cash commission. The cash would have to be

provided through the sale of a large amount of the underlying security, the new 4's, and would by so much lessen the proportion of assets to debt of that security. They would also consider it desirable that at least part of the bankers' compensation should be in such form that the bankers would be more likely to have a continued interest in the business.

We have assumed a substantial speculative value for this new stock. Earnings are already sufficient almost to cover the requirements of the new preferred stock. Let us assume that the default took place during a time of financial panic followed by a period of business depression. As a result of the bad business period the receiver has not been able to show a material increase in earnings. With a period of reviving business a substantial increase in earnings may reasonably be expected. Practically all of any increase in net will become available for dividends on the common stock. Though presumably a policy of dividend payment would not be undertaken immediately on any increase in net, a stockholder may reasonably expect that within a few years dividends will be forthcoming on the common stock. Under the plan outlined there is only a relatively small amount of stock to absorb increased earnings, the total of \$5,875,000 in the hands

of the old bondholders, the old preferred and common stockholders, and in the hands of the syndicate. The large block of \$14,125,000 of stock held for corporate requirements is practically, and may be made actually, treasury stock. If any of it is disposed of, it will increase the assets, and consequently, it is to be presumed, also the earning power, of the corporation.

A word should be said about the preferred stock provided in the plan proposed, though the reorganization committee may be able to get the old security-holders to convert part of their old interest charge into a mere dividend, expecting that the old security-holders would probably insist that they shall not run the risk of their expectancy of preferred dividends being made more remote through the creation of a prior claim against the earnings. In order to get its proposal accepted, the committee will have to make it one of the provisions of the preferred stock that no such prior claim shall be created. It may be able to modify this provision to one permitting such a claim to be created on the approval of two thirds or three quarters of the preferred stockholders. Such a provision might seriously hamper the financing of the corporation in future years and the preferred stock might very well be made redeemable. It

might, perhaps, also be made convertible, so that if the corporation should greatly prosper it would disappear through the conversion process.

It should be noted that our hypothetical plan does not reduce the par of the new securities to be distributed to the old bondholders, but, in order to render more palatable the adulteration of the security of the bondholder, the plan even increases the par value of the new securities offered to him. Though part of the new securities is in stock, and the possibility of income return is the only thing of importance, the investor's mind, nevertheless, clings to par values, and the old security-holder does not feel such a sense of loss if the par of his holdings remains unimpaired.

In our hypothetical reorganization we have had the cash requirements supplied by the bankers and the old stockholders. These sources would be possible in such a case as presented, largely because the earning power of the railroads, even at its low ebb, was still almost sufficient to meet the interest requirements. Under those circumstances, as already pointed out, stock would have a speculative value. On that basis old stockholders will come forward with some funds. The new bonds, so greatly reduced in amount from

those in default, have so substantial a value as to be marketable. To be sure, they will sell at a discount, but that is because the interest rate is made so low, 4 per cent. Though it would more normally be 5, the 4 per cent rate was decided on in order to allow so substantial a par value to be offered as to placate the old bondholders, and still substantially cut down the fixed charges. If the financial condition of the corporation had been worse, the burden of supplying new cash might have been thrust upon the bondholders. They would have to supply it in order to prevent the property from going entirely to wreck. Depending upon conditions, any class of security-holders may be asked to supply cash, even those holding the current debt of the corporation. Calling on the bondholder to contribute new cash is found to be unpopular. He is certain to have some of the feeling of "throwing good money after bad." Stockholders contribute any part of the new funds only under the strongest inducement. Though the contribution is for them also a throwing of good money after bad, they are reluctant utterly to part even with the "bad" money. Bondholders can be made to contribute only when their position comes to approximate that which shareholders are usually in: they must contribute some or lose all.

Indeed, though the general procedure of one reorganization is much the same as that of another, the financial plans present very wide variations depending on the particular conditions of each case. Rather than follow through an actual reorganization which would present many problems of detail that might confuse one considering the subject for the first time, we have taken an imaginary case which we could make as simple as we chose. It should not be understood that the hypothetical case presented is even typical. The elements were chosen to show the situation as simply as possible.

Our imaginary case does not present one often very important situation, that of the lease. If a reorganization involves an enterprise with leased property, those in charge of the reorganization must come to terms with the owners of the leased property. Of course, they may not consider it desirable to retain the leased property in the enterprise. The receiver may already have exercised his right to disaffirm the lease and cut this part of the property loose, or it may otherwise be cut loose in the course of the reorganization. Since it is not owned by the corporation undergoing reorganization, it does not form part of the property in the foreclosure sale. Generally the owners of the leased property

do not want it back on their hands to operate. They have no operating organization. So they are likely to make terms, if they can, in the reorganization. Frequently the making of terms results in changing the status of the property from its former lease to an actual ownership. The leased property is consolidated into the reorganized enterprise. Sometimes, but not usually, an arrangement is made reducing the rental. The whole matter is part of the general problem of reducing fixed charges. The lease may be in so strong a position as to be undisturbed, like the underlying bonds. It may be so weak that it is not desired at all, and can be cut off even more effectively than the stockholders' equity. Or it may be strategically in the position of the bonds in default, and have to suffer a scaling down in some way.

Reorganization expenses are allocated directly to the depositors, and are not provided for in the cash requirements. Any securityholder who has deposited and subsequently withdrawn will have to pay his *pro rata* of the expenses up to the time of his withdrawal. That would ordinarily be up to the time of the announcement of the plan of reorganization. In an organization more complex than the one we have presented, the reorganization committee would have to determine what

proportion of the expenses each issue involved in the reorganization would have to bear.

We have presented only one device for scaling down fixed charges, that is, by a substitution of stock in the place of interest-bearing securities. This is the best method, but is not always followed. A plan more commonly adopted in earlier reorganizations than recently was the substitution of income bonds for bonds with less elastic interest provisions. The objectionable characteristics of income bonds were discussed in the first volume. In substance, from the standpoint of a security-holder in reorganization, income bonds give practically no greater assurance of payment of income than a preferred stock, and lack the voting power which helps the preferred stockholder protect his position.

The "adjustment bond" is another device resorted to in reorganizations to effect an immediate reduction in fixed charges. The reorganization committee may ask the old bondholders, whose securities carried interest, let us say, at 5 per cent, to take new bonds carrying interest for the first year say of 2 per cent, for the second year of 3 per cent, for the third year of 4 per cent, and the fourth year reaching the interest return of the replaced securities of 5 per cent. Though these rates

involve an immediate cutting-down of the bondholder's income, they include a definite and absolute promise that the income will be restored by the steps indicated. This places the security-holder in a stronger position than the expectancy of income offered by a preferred stock. From the standpoint of the probable permanency of the reorganization it is not so good as the preferred stock. If the reorganization committee relies upon it to effect the entire scaling down and does not materially reduce the principal amount, fixed charges will go back to their original amount at the end of the four-year period. Since the committee is not likely to get the bondholders to accept a reduction of both principal and rate of income, the principal amount will probably remain unimpaired. The adoption of the device of the adjustment bond indicates a reliance on increasing earnings. If this expectation should not be realized, the corporation would again face reorganization.

For the reorganization plan we have followed through, we have had the reorganization managers assume the burden of the work of effecting the purchase and of distributing the securities. The position of the underwriting syndicate involved only the taking-up of such of the securities provided for the raising of cash as the old stockholders did not

subscribe for. After formulating the new financial plan, the reorganization managers might have turned the whole matter over to the syndicate if they had made such an agreement. In that event, the syndicate, which we have termed the "underwriting syndicate," would be denominated the "purchase syndicate." It would have bought the property at the foreclosure sale, turned it over to the new management for the securities, and distributed the securities in accordance with the provisions of the agreement the syndicate had made with the reorganization committee. This agreement would have included the same distribution of the new securities as we have discussed. In this, as in every other aspect of a reorganization, the details may vary widely. In the space at our disposal there is opportunity to discuss only the general principles involved.

. READJUSTMENT OF THE CAPITAL ACCOUNT

We have restricted our use of the word "reorganization" to situations involving a foreclosure, or otherwise a sale of the property at the instance of creditors. Common use applies this term more broadly to include any substantial change in the financial plan, not only when there is no sale at the instance of creditors, but even when the change does

not at all result from insolvency. It seems in the interest of a more careful nomenclature to reserve the term "reorganization" to cover such cases as we have already discussed.

Sometimes substantial changes are made in the plan of capitalization as a result of insolvency without involving a judicial sale. This can most advantageously be done when, though the assets are ample, some business reason has made it impossible for the corporation to meet its interest charges or its maturing obligations. It can sometimes be forced through when a class of creditors realizes that a reorganization involving a judicial sale would cut them off or would reduce the amount they are apt to realize from their claims below the amount they believe the values really in the property ought to produce for them. It may especially be utilized when the stockholders believe that the insolvency is temporary and are willing to aid substantially in having the finances arranged in some way that will not involve cutting off their equity. Any creditor whose claim remains unpaid can eventually force a judicial sale of the assets, and those interested in effecting a solution of the corporation's financial troubles can hold this whip over those who are inclined to block, or refuse to support,

endeavors to procure an adjustment without such a sale. If the financial difficulties are surmounted without a judicial sale in a way that involves substantial changes in the financial plan, we will say that there has been a "readjustment of the capital account."

A readjustment involves much the same matters as we have discussed under the heading of "Reorganization," but it is carried through without the judicial sale. The property is not, however, transferred to a new corporation, and new securities, including the new stock, issued in payment for the property transferred to the new corporation. Since, generally speaking, no property is being transferred in any way, any new stock issued must be paid for in cash at par. Either the stock of the corporation must be worth par in spite of the present embarrassment, or worth so near par that parties having an interest in the situation are willing to pay par for it in order to straighten out the situation and avoid greater loss in some other direction.

Of course, it would be rather extraordinary that the common stock of an insolvent corporation should be worth par. Ordinarily, if new stock is to be issued an issue of preferred stock would have to be authorized. Or, if there is an existing issue of preferred stock, a new issue with a prior preference may be

created. The stockholders may be sufficiently interested in carrying out the readjustment to contribute some of their holdings to the corporation, which, becoming treasury stock, the corporation may proceed to sell at less than par. This would involve practically unanimous action, otherwise some of the stockholders would be making a sacrifice for the benefit of other stockholders who are not sacrificing at all.

The readjustment of the Westinghouse Electric and Manufacturing Company following the financial crisis of 1907 presents a good illustration. The company had been expanding its business rapidly, and as a result had a large floating debt, the maturities of which the corporation was unable to meet in the face of the existing stringent financial conditions. This debt consisted of two classes: (1) merchandise debt or credit given by concerns which furnished materials to the company, and (2) bank debt, the result of floating the company's paper generally throughout the country and of borrowings from the local banks. The business depression which set in after the general financial crisis of the fall of 1907 caused a marked falling-off in the earnings of the company and made its situation one of great difficulty. Several plans for readjustment failed before one finally succeeded.

A business situation proved really the pivotal point. Merchandise creditors naturally looked forward to continuing business with the rehabilitated company. It frequently happens that in smaller enterprises than the Westinghouse business adjustments are made on this principle. If those in charge of a business are known to have such abilities and reputations that they will continue in the same business and use the same materials after their financial difficulties are adjusted, their merchandise creditors are likely, rather than force them through bankruptcy, to make a composition with them in the expectation of continuing their good-will. Such creditors expect to benefit through the profit of future business more than enough to make up present losses. By forcing the debtor into bankruptcy they would lose his good-will and probably gain nothing over the composition. The Westinghouse difficulties presented a case in which those who were creditors on account of current liabilities were most immediately concerned. The merchandise creditors wanted to continue in the good-will of the dominating interests in the enterprise for the sake of future business. The local banks also looked to future business. These two divisions of the creditors were the easiest to deal with.

• Other bank creditors presented a more

difficult problem for those who were seeking to arrange the finances of the company. For the various reasons which make it necessary or expedient for a concern like the Westinghouse Company to seek a broader area of credit than the local community, it had through note brokers placed large amounts of its paper with banks throughout the country. These banks had nothing to gain from business relationships with the concern. Whatever they were to rescue from the situation they had to salvage at once. They were not so easy to deal with.

Under the plan that finally gained acceptance, merchandise creditors to the amount of some \$4,000,000 agreed to take stock of the company at par in the settlement of their claims. The plan offered the bank creditors 50 per cent of their claims in convertible long-term bonds. They were given an option of several proposals in settlement of the other 50 per cent of their claims: (1) to take 30 per cent in four, five, and six year notes and 20 per cent in stock; (2) to take it entirely in fifteen year notes; (3) to take it entirely in stock. There was about \$8,000,000 of this bank debt.

The concern required some actual cash, however, to get its affairs straightened out. The stockholders were asked to subscribe to

\$6,000,000 of stock at par. Though the concern was embarrassed with its large floating debt, its assets and earning power in normal times made its stock valuable. During this period, however, the stock was not selling in the general market at par, and the purchase of stock at par was equivalent to making a cash contribution to the treasury of the company. Only the large stockholders saved the situation at this point. With some banking assistance they came forward and subscribed for the necessary amount of new stock. Of course, no compulsion could be put on the stockholders, and, as the corporation was issuing this stock for cash, it had to be sold for par.

Non-local bank creditors did not look with much favor on the proposals made to them. A gradual revival in business conditions, however, made it seem probable that the new securities would have a sufficient value at least to let them out whole, and finally they agreed to the plan.¹

Only the threat of a judicial sale makes possible a voluntary readjustment of the

¹ The facts here presented about the Westinghouse readjustment are gathered from Dewing's *Corporate Promotions and Reorganizations* (Harvard University Press, 1914). The reader is referred to that volume for a complete and interesting discussion of this readjustment of the capital plan.

capital account: Do this or worse things will happen to you. Even with this threat, generally anything requiring a unanimous consent cannot be carried through. Some recalcitrant (from the viewpoint of those trying to carry through the readjustment) will refuse to act except under court compulsion. Yet, if the number of people who are directly affected is not too great, and if the situation is strong enough, sometimes practically unanimous action may be had. In a sufficiently strong situation the writer once succeeded in getting all of the second mortgage bondholders of an enterprise to agree to accept the position of third mortgagees in order that cash might be provided by a smaller issue of bonds with a second mortgage claim.

RECAPITALIZATION

By the term "recapitalization" we mean a substantial change in the financial plan of the corporation that does not result from insolvency. Quite the contrary situation is the most frequent cause of recapitalization. Those in control of the corporation bring about an increase in the outstanding securities to make their par present more nearly the actual capital value of the business. This situation frequently arises when an incorporated family enterprise is being turned into one for

general market purposes. Many enterprises have their origin, not in an original large promotion, but through the growth of some small business undertaken by an individual or a very small group of individuals. Very likely the business was not incorporated at the beginning, but was started as entirely a matter of direct individual proprietorship or as a partnership affair. Some of the various reasons for incorporating finally led the proprietors to take the step of incorporation. The business grew and the owners added to the capital account out of the earnings, so that the present value of the plant is far in excess of the capitalization. It may be that the business has passed through the hands of several generations in this way. Or it may be that the business met with rapid and large success. In recent years the automobile industry has presented examples of especially swift expansion, and the building-up of assets out of earnings. Whatever the business, let us assume that for some reason a time has come when the owners are willing to part with their exclusive ownership and admit outside capitalists to an interest in the business. It may be that one of the present owners wishes to withdraw and the owners are not able or are not ready for any other reason to buy out his interest. Perhaps an owner has died and

the beneficiaries of his estate want to liquidate his interest in the business. Very likely the present owners wish now to expand the business more rapidly than they can exclusively out of earnings. For one of these reasons, or for any other, they want access to the general market for capital, and are prepared to part with some of their stock interest. Their present stock, however, is worth too high a premium to be disposed of advantageously in the general market. So they must recapitalize.

Let us assume the case of a business which has taken advantage of the principle of trading on the equity and in times past has borrowed some capital by issuing bonds, so that its capitalization now stands in this way: —

Stock.....	\$250,000
Bonds.....	1,000,000

Its earnings, however, show that the capitalization does not represent the actual values in the business. Let us say that the income account shows in a normal year: —

Net earnings.....	\$525,000
Interest.....	<u>50,000</u>
Available for dividends.....	\$475,000

A careful management would advise carrying \$50,000 of this to a reserve account, and leave for actual distribution \$425,000. This

approaches 200 per cent on the present capitalization, and would exceed 7 per cent on a capital stock of \$6,000,000. Let us assume that an appraisal would show a valuation of assets of \$7,000,000 so that the corporation, considering its \$1,000,000 of bonds, may properly increase its capital stock outstanding by \$5,750,000.

The owners decide to increase the capital stock authorized to \$8,000,000 and declare a stock dividend of 230 per cent. Let us assume that the purpose of the stockholders in doing this was to permit such of them as chose to dispose of part or all of their ownership in the business, and that, as a matter of fact, the owners of a quarter interest wish to dispose of all their holdings, and enough others wish to realize some cash to dispose of one twelfth more of the ownership of the business. Since the stock is "full paid," they can dispose of it at any price they see fit.

If the recapitalizing were done with a view to providing cash for corporate purposes, the private owners would have agreed to contribute such a *pro rata* of the stock dividend to that end. They may sell, let us say, \$2,000,000 of the stock at 90, and raise \$1,800,000 for the corporation. Putting through such a transaction by means of recapitalizing would depend upon unanimous consent,

and would be practicable only in the case of corporations with a very small number of shareholders.

Sometimes the situation may be just the opposite of that we have described. Though a corporation may be solvent, it may have so large an amount of stock outstanding and its earnings be so small that there can be no hope of a policy of dividend declaration on the existing stock. This situation is more likely to exist with corporations which have large amounts of preferred stock, especially if it is cumulative and has arrears of dividends. In such case the corporation can simply go through the legal procedure for reducing capital stock.

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